SUPREME COURT, U. S.
FILED
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NO. 1005

IN THE

Supreme Court of the United States

October Term, 1966

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SUPREME COURT, U.S.

REEF CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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INDEX

	Page
Citation to Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes Involved	7
Statement	7
Reasons for Granting the Writ	11
Conclusion	30
Appendix A	31
Appendix B	61
Appendix C	68
Appendix D	72
Appendix E	87

CITATIONS

CASES

	Page
James Armour, Inc., 43 T.C. 295 (1964)	20, 21
Cabot Corp. v. U. S., 220 F.Supp. 261, 326 F.2d 753	4, 27
Columbia Gas of Maryland, Inc. v. U. S., 66-2 USTC ¶ 15,711	4, 26
Commissioner v. Brown, 380 U.S. 563	3, 5, 11, 12, 25, 28
Commissioner v. Court Holding Company, 324 U.S. 31	14
Commissioner v. Morgan, 288 F.2d 676	19, 20, 21
Cortlandt Specialty Co. v. C.I.R., 60 F.2d 937 (2 CCA)	3, 19
Joseph C. Gallagher, 39 T.C. 144	4, 25
Gregory v. Helvering, 293 U.S. 465	5, 11, 14
Hanover Bank v. C.I.R., 369 U.S. 672	5, 28
Helvering v. Flaccus Leather Co., 313 U.S. 247	5, 28
Helvering v. Hammel, 311 U.S. 504	5, 28
Helvering v. Southwest Consolidated Corporation, 315 U.S. 194	4, 25

CASES

	Page
W. P. Hobby, 2 T.C. 980	3, 12
LeTulle v. Scofield, 308 U.S. 415	3, 4, 19, 23
Moline Properties, Inc. v. C.I.R., 319 U.S. 436	4, 25
National Carbide Corporation v. C.I.R., 336 U.S. 422	4, 25
Old Colony Railroad Co. v. C.I.R., 284 U.S. 552	5, 28
Pinellas Ice & Cold Storage Co. v. C.I.R., 287 U.S. 462	3, 19, 23
Sun Properties, Inc. v. United States, 220 F.2d 171 (5 CCA)	3, 12
Turnbow v. C.I.R., 368 U.S. 537	5, 28

STATUTES

Internal Revenue Code, 1939

Sec. 112(b)(3)	16, 17, 18, 21
Sec. 112(c)(2)	20
Sec. 112(g)	16, 17
Sec. 112(g)(1)(D)	19

Internal Revenue Code, 1954

Sec. 163(a)	7
Sec. 248	5
Sec. 301(a) and (c)	7
Sec. 302(a) and (b)	7
Sec. 337(a)	7
Sec. 354	16, 21
Sec. 354(a)	3, 7, 17, 18, 21
Sec. 354(b)	3, 7, 17, 18, 21
Sec. 362(b)	7
Sec. 368(a)(1)	7, 17
Sec. 368(a)(1)(D)	3, 4, 6, 7, 11, 15, 16, 17, 19, 21, 22
Sec. 368(a)(1)(F)	3, 4, 5, 6, 7, 11, 25, 26, 27
Sec. 453(b)	7
Sec. 1201(b)	7
Sec. 6212(a)	5, 7, 28
Sec. 6212(c)	28
Sec. 6213(a)	7, 28

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REEF CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner, Reef Corporation, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case (No. 22,836 below), affirming that part of the judgment of the Tax Court of the United States adverse to petitioner and reversing that part of the judgment of the Tax Court of the United States in favor of petitioner.

CITATION TO OPINIONS BELOW

The opinion of the Tax Court (R. 229-289), is reported in 24 TCM 379. The opinion of the Court of Appeals (R. 314, *infra*, Appendix A, p. 31), is not yet reported.

JURISDICTION

The judgment of the Court of Appeals, affirming that part of the judgment of the Tax Court unfavorable to petitioner and reversing that part of the judgment of the Tax Court favorable to petitioner, was entered on October 25, 1966 (R. 314-344, *infra*, Appendix A, p. 58). On November 25, 1966, petitioner filed its Motion for Rehearing (R. 345). Nine copies of that Motion are filed with the Court herewith. The order of the Court of Appeals denying the Motion for Rehearing was entered on December 15, 1966 (R. 380, *infra*, Appendix A, p. 59). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. In 1958 the Butler group and Favrot group owned approximately one-half each of the stock of Reef Fields Gasoline Corporation (herein "Reef Fields") but no notes or other securities of Reef Fields. The Butler group formed petitioner, Reef Corporation, (herein "Reef") with a capital of $574,800 paid for with 3,832 shares of Reef Fields' stock. The Butler and Favrot groups and Reef sold all the stock of Reef Fields to the George Strong Trust, the Favrots receiving $1,217,000 in cash and the Trust's notes for $1,703,800, the Butlers receiving $2,624,400 notes of the Trust and Reef receiving $574,800 of such notes. Reef Fields thereafter made a contract with Reef under which it sold its assets, except $1,217,000 in cash, to Reef for Reef's notes totalling $4,903,000, and immediately dissolved and distributed to that Trust as its sole stockholder $1,217,000 in cash and the Reef notes of $4,903,000, which notes the Trust pledged to secure its $4,903,000 of

notes. On $3,883,000 of the notes the Trust had a spread of ¼% interest between the interest on its notes and those of Reef it held, giving it a profit of $9,707.50 a year. On April 27, 1964, when the case was tried in the Tax Court, $2,378,000 of the notes had been paid off, leaving outstanding only $2,525,000 of both the Reef and the Trust's notes.

May the lower courts ignore the sale to the Strong Trust and its notes, hold that Reef Fields sold its assets to Reef for its notes, that the notes should be treated as stock and that this was a reorganization of Reef Fields under both section 368(a)(1)(D) and (F) of the Internal Revenue Code? Such a holding is in direct conflict with *Commissioner v. Brown*, 380 U.S. 563; *W. P. Hobby*, 2 TC 980; *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5 CCA), and many similar cases holding that taxpayers may handle their transactions in such manner as they desire for the purpose of reducing their tax liability.

2. If the sale to the Strong Trust is ignored, was the Court of Appeals correct in holding that there was a reorganization between Reef Fields and Reef under sec. 368(a)(1)(D) of the Internal Revenue Code? Such a transaction wholly failed to meet the requirements of (D) and also of sec. 354(a) and (b) of the Code.

3. If the sale to the Strong Trust is ignored, was the Court of Appeals correct in holding that the notes of Reef were not notes but were to be treated as stock? Such a holding is in direct conflict with *Cortlandt Specialty Co. v. C.I.R.*, 60 F.2d 937 (2 CCA), *Pinellas Ice & Cold Storage Co. v. C.I.R.*, 287 U.S. 462, and *LeTulle v. Scofield*, 308 U.S. 415, all holding that notes may not be treated as stock.

4. If the sale to the Strong Trust is ignored, was the Court of Appeals correct in holding that there was a reorganization of Reef Fields into Reef under sec. 368(a)(1)(F) of the Code? Such a holding, from which Judge Bell of the court below dissented, is directly contrary to *Helvering v. Southwest Consolidated Corporation,* 315 U.S. 194, and *Joseph C. Gallagher,* 39 T.C. 144, and the holdings in *Moline Properties, Inc. v. C.I.R.,* 319 U.S. 436, and *National Carbide Corporation v. C.I.R.,* 336 U.S. 422, that the separate existence of corporations may not be ignored. The holdings of the courts below on section 368(a)(1)(F) are also in conflict with the decision of the Court of Claims of October 14, 1966, in *Columbia Gas of Maryland, Inc. v. United States,* 66-2 USTC ¶ 15,711, and not yet otherwise reported, and the decisions referred to therein of *Cabot Corporation v. United States,* 220 F. Supp. 261 (D. Mass. 1963), affirmed 326 F.2d 753.

5. If the sale to the Strong Trust is ignored, was the Court of Appeals correct in holding that Reef's Notes constituted stock and the payment by Reef on the interest accruing that became due and payable each six months on its Notes was not deductible as an interest expense under section 163(a) of the Internal Revenue Code? Such a holding is in direct conflict with the decision of this Court in *LeTulle v. Scofield,* 308 U.S. 415, and other cases hereinafter referred to.

6. May the Court of Appeals hold that, since Reef Fields (1) could have organized Reef and received the latter's stock (2) could have then sold its properties to Reef for Reef's Notes and (3) could have then distributed its own $1,217,000 cash and part of the Reef Notes to the Favrot group and part of those Notes to the Butler group, there was therefore a reorganization under sec. 368(a)(1)(D)

and (F) of the Code? Such a holding is in direct conflict with this Court's holding in *Gregory v. Helvering*, 293 U.S. 465, that taxpayers may arrange their affairs so as to reduce their tax liability, and the holdings of this Court that the Internal Revenue Code is to be interpreted and applied as it is written. *Commissioner v. Brown*, 380 U.S. 563; *Old Colony Railroad Co. v. C.I.R.*, 284 U.S. 552; *Helvering v. Hammel*, 311 U.S. 504; *Helvering v. Flaccus Leather Co.*, 313 U.S. 247; *Hanover Bank v. C.I.R.*, 369 U.S. 672; *Turnbow v. C.I.R.*, 368 U.S. 537, and many other cases.

7. The lower courts improperly held that the basis to Reef Corporation of its assets were those of Reef Fields, that it was not entitled to deduct depreciation based upon the cost of those assets as evidenced by its purchase of them from Reef Fields, and that it might deduct no organization expense under section 248.

8. Reef Fields filed its income tax returns on the fiscal year basis from July 1 to June 30. Reef was incorporated on December 15, 1958, and adopted the fiscal year ending June 30. Reef Fields was dissolved on April 27, 1959. Reef's first income tax return was for the period from December 15, 1958, to June 30, 1959, and Reef Fields' final return was from July 1, 1958, to April 27, 1959. (R. 153, 171) On December 21, 1962, the Commissioner, pursuant to section 6212(a), mailed by certified mail a notice addressed to "Reef Corporation" proposing to assess the income taxes involved in this case for its taxable period from December 15, 1958, to June 30, 1959. On the same day, the Commissioner, pursuant to section 6212(a), mailed by certified mail a notice addressed to "Reef Corporation (Successor in name to Reef Fields Gasoline Corporation)" proposing to assess deficiencies for the year from July 1, 1958, to

June 30, 1959. On February 25, 1963, Reef Corporation filed in the Tax Court its petition appealing from the deficiency notice covered by the letter addressed to "Reef Corporation", the case being styled Reef Corporation, Petitioner vs. Commissioner of Internal Revenue, Respondent, Docket No. 788-63. (R. 152-166) On the same day, petitioner filed in the Tax Court its petition appealing from the deficiency notice covered by the letter addressed to "Reef Corporation (Successor in name to Reef Fields Gasoline Corporation)", the case being styled Reef Corporation, Petitioner vs. Commissioner of Internal Revenue, Respondent, Docket No. 789-63. (R. 170-188) Attached to the petitions in each case as Exhibits A and B were copies of those deficiency letters. The printer, contrary to instructions of petitioner, failed to print those two deficiency letters in the record. They are set forth as Appendix E to this brief. A reading of the letters will show that for the major part they cover the same items of disallowances. Petitioner in each case pleaded these facts. (R. 154-155, 173-174) Petitioner pleaded that it was unknown which letter was mailed first and under section 6212(c) the Commissioner, after mailing one notice, could not legally mail the other notice. (R. 154-155, 173-174) The Government admitted that they could not tell which notice was mailed first. (R. 23) Petitioner therefore pleaded and claims that neither of the notices was valid. The Tax Court held that there was a reorganization under section 368(a)(1)(D) but not one under section 368(a)(1)(F), that the notice addressed to Reef Corporation (Successor in name to Reef Fields Gasoline Corporation) was invalid and that therefore the other one addressed simply to Reef Corporation was valid. The Government appealed and on its appeal the Court of Appeals held that there was a re-

organization under both section 368(a)(1)(D) and (F) and reversed the Tax Court in dismissing cause No. 789-63 as the notice to "Reef Corporation (Successor in name to Reef Fields Gasoline Corporation)" was valid. Thus, Reef is faced with both notices. This Court should pass upon the question as to whether sections 6212(a) and (b) and 6213(a) are to be interpreted so as to allow the Commissioner to send out two such deficiency letters at the same time.

STATUTES INVOLVED

The applicable statutes are sections 163(a), 301(a) and (c), 302(a) and (b), 337(a), 354(a) and (b), 362(b), 368(a)(1), 453(b), 1201(b), 6212(a) and (c) and 6213(a) of the Internal Revenue Code. They are set forth in Appendix B hereto.

STATEMENT

The statement of the Court of Appeals and the one apparently upon which it based its decision ignoring the Strong Trust (R. 320)

> "He carried out a sales contract already entered into between the corporations. * * * Cf. Court Holding Company, 1945, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981."

is wholly unsupported by the record and in fact contrary to the actual facts. The facts are accurately set forth in the petitions in both cases but for the sake of simplicity we refer to that in No. 788-63 at R. 157-165. The facts therein set forth are fully supported by the testimony and the original exhibits now with the Court of Appeals.

The Butler group consisting of Butler, Miller and Lents, engineers, and some of their associates ran Reef Fields. The Favrot group were largely investors that had furnished money for the Company through stock. Each owned approximately 50% of the stock of Reef Fields. On December 15, 1958, the Butler group incorporated Reef and paid for its stock with 3,832 shares of Reef Fields stock having an agreed value of $574,800. Reef proposed to buy the assets of Reef Fields with its notes of $4,903,000 and have Reef Fields dissolved. The stockholders of Reef Fields refused this proposition as they would immediately have a capital gains tax to pay but would have only notes of Reef and no cash with which to pay the tax.

The George Strong Trust was a small trust with George Strong as its trustee. The beneficiaries owned no stock in Reef Fields except The Favrot Fund owned 244 shares out of 40,800 outstanding. On December 30, 1958, the Trust bought from the Favrot group 19,472 shares of Reef Fields at $150 a share for $1,217,000 cash and its C Notes for $1,217,000 and E Notes for $486,800. Thereafter, on December 30, 1958, the Trust and the Butler group owning the balance of the stock had Reef Fields adopt a plan of liquidation under Section 337 under which the directors were authorized to sell its properties on such terms as they decided. Thereafter, the directors authorized a contract with Reef under which Reef would on February 28, 1959, buy all the assets of Reef Fields except $1,217,000 in cash and would give Reef Fields its notes as follows:

A Note	$1,093,500
B Note	239,500
C Note	2,310,500
D Note	239,500
E Note	924,200
F Note	95,800

In January, 1959, the Trust purchased the remaining 17,496 shares owned by the Butler group and the 3,832 shares owned by Reef and gave them its notes as follows:

	Butler Group	Reef
Series A	$1,093,500	
Series B		$239,500
Series C	1,093,500	
Series D		239,500
Series E	437,400	
Series F		95,800
	$2,624,400	$574,800

Reef Fields then distributed to the Trust $1,217,000 in cash and the Series A to F Notes of Reef which the Trust then pledged to secure its Series A to F Notes held by the Favrot group, the Butler group and Reef.

The sale to Reef by Reef Fields was completed at the close of February 28, 1959, and Reef thereupon executed four mortgages dated March 2, 1959:

1. A First Mortgage to an insurance company securing a note of $3,000,000.

2. A Second Mortgage to secure its Series A and B Notes, subordinate to the First Mortgage.

3. A Third Mortgage to secure its C and D Notes subordinate to the First and Second Mortgages.

4. A Fourth Mortgage to secure its Series E and F Notes subordinate to the First, Second and Third Mortgages.

The First Mortgage provided a formula to determine the amounts payable on the insurance company loan. The Second and Third Mortgages provided for the same schedule

of payments after the insurance company was discharged, first to the payment of Series A and B Notes and then to Series C and D Notes. The Series E and F Notes were payable out of 1/6 of the net income realized by Reef after the other Notes were paid.

The Trust's pledge agreements required that all payment on the pledged Notes be applied on the Trust's Notes except for the differential in interest referred to below.

The Notes bore the following rates of interest:

	Trust's Notes	Reef's Notes
Series A and B	5½%	5¾%
Series C and D	6%	6¼%

Thus, the Trust had a spread of ¼% per annum on an initial total of $3,883,000 or $9,707.50 per year which it was not required to turn over to the holders of its Notes.

The Reef A to D Notes expressly provided that the interest should be payable semi-annually on the last day of June and December as it accrued and that, if any installment of interest or principal were not paid when due, the Notes could be declared immediately due and payable. The mortgages also provided that, if the earnings of Reef in any year were greater than the amounts required to be paid on the insurance company's note, the excess must be paid upon its Notes A to D. At the trial of this case in the Tax Court on April 27, 1964, Reef's A, B and D Notes had been paid in full as well as $805,500 of the C Notes, leaving out of the original total of $4,903,000 of Notes only $2,525,000 unpaid.

Reef in its income tax return deducted depreciation on the basis of the cost of the properties to it, deducted

its organization expense allowed under section 248, and deducted the interest paid on its Series A to D Notes. The Commissioner held there was a reorganization under section 368(a)(1)(D) and (F), that Reef's basis was the same as the basis of Reef Fields and disallowed a large amount of depreciation, disallowed the organization expense, and disallowed Reef's deduction of the interest paid on its Series A to D Notes.

REASONS FOR GRANTING THE WRIT

1. In *Gregory v. Helvering*, 293 U.S. 465, this Court laid down the rule at 469:

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States v. Isham, 17 Wall. 496, 506; Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-6; Jones v. Helvering, 63 App. D.C. 204; 71 F.(2d) 214, 217."

That is all that the taxpayers in this case were doing. These transactions occurred in December, 1958, long before there were any decisions whatsoever interpreting section 368(a)(1)(D) or (F) in the manner followed by the two lower courts. No one at that time even dreamed that, if Reef purchased the assets of Reef Fields for its notes and Reef Fields distributed those notes to its stockholders and dissolved, this could possibly be a reorganization under section 368(a)(1)(D) or (F). What the taxpayers were concerned with was the fact that, if they went that way, they as stockholders would have a big capital gains tax to pay for 1958 but would have only paper notes of Reef. Therefore, they simply did what has been expressly approved by this Court as recently as *Commissioner*

v. Brown, 380 U.S. 563, and by the lower courts in *W. P. Hobby,* 2 T.C. 980, and *Sun Properties, Inc. v. United States,* 220 F.2d 171 (5 CCA) and many other cases. This Court is familiar with its decision in the *Brown* case and we will not discuss it in detail. However, we call attention to the statement of the Court of Appeals below in reference to that case (R. 320-321).

> "New Reef places primary reliance on the case of Commissioner v. Brown, 1965, 380 U.S. 563, 85 S.Ct. 1162, 14 L.Ed.2d 75. That case, however, is distinguishable. There was arm's length bargaining by the intermediate purchaser in that transaction, here there was not; the intermediate purchaser there acquired unfettered ownership and here Strong did not. Strong was in effect acting to service a contract rather than as a purchaser."

We do not think that this Court will accept that statement as accurate or as distinguishing the position of the Strong Trust from that of the Foundation involved in *Brown.* The lower court said that there was no liability on the part of the Strong Trust. The foundation in the *Brown* case had no liability. The courts below referred to Strong as being an attorney for the taxpayers. In the *Brown* case the corporation ending up with the properties was owned by the attorneys of the sellers.

The court below also says that he

> "received only nominal consideration for his services."

That court completely missed the point that it was not Strong individually but it was the Strong Trust that was acting. We have shown that the Trust had a spread of ¼% on the amount involved. This position of the Government and of the lower courts is in strange contrast to

the practice that the Treasury Department has followed at least since 1941 expressly approving what are known as the ABC transactions in the oil business where the middle man makes only a profit of approximately 1/8% on the amount involved. Billions of dollars of oil properties have been sold since 1941 on these ABC deals approved by the Treasury Department. This is one of the reasons such high prices are now paid for oil properties. Let us take a typical example: In 1963 S oil company was willing to sell its properties for not less than $90,000,000. B oil company wanted to buy them but, if it paid $90,000,000 in cash, it would be taxed with all the income subject only to depletion and would have great difficulty in paying off such an amount. So it arranged to purchase the properties for $90,000,000 in an ABC transaction. S oil company sold the properties to B oil company for $12,600,000 in cash but reserved a production payment of $77,400,000 payable out of a part of the oil and gas to be produced, plus an amount equal to 5 3/8% per annum on the unliquidated balance of the production payment. S oil company contemporaneously sold the production payment to F finance company for $77,400,000 cash. F finance company then borrowed the $77,400,000 from banks on notes bearing 5 1/4% per annum with the notes secured by a mortgage of the production payment. There the F finance company had a margin of only 1/8% between what it had to pay the banks on its loan and the amount it obtained on the production payment. (In this case the Strong Trust had a margin of 1/4%.) The Internal Revenue Service, following the practice it has pursued since around 1941, held that this whole transaction was valid and the income from the production payment was income to F finance company even though its margin was only 1/8% of the unliquidated balance each year of the production

payment. We quote the following parts of the ruling by the Internal Revenue Service:

> "1. The production payment will be a depletable economic interest in the hands of F finance company and proceeds realized from the sale of production attributable thereto will be includable in the gross income of F finance company, and will be subject to the depletion allowance. See Thomas v. Perkins (1937), 301 U.S. 655 and Anderson v. Helvering (1940), 310 U.S. 404.
>
> "2. The basis for cost depletion to F finance company will be the amount of purchase price of the production payment paid by F finance company plus any costs incident to the acquisition of the production payment paid by F finance company."

In this case the stockholders of Reef Fields were not trying to avoid any tax. They knew and admit they would have to pay a capital gains tax. They did not want to become liable for such a large tax in 1958 on the dissolution of Reef Fields when they would receive only notes of Reef. They, therefore, arranged for the sale of their stock to the Strong Trust so that they could report their capital gains on the installment basis under section 453(b) of the Code. They were doing just exactly what this Court said they might do in the *Gregory* case. Strong was not doing what the Court of Appeals said when it stated that

> "He carried out a sales contract already entered into between the corporations. * * * Cf. C.I.R. v. Court Holding Co., 324 U.S. 331."

He carried out no contract and any thought of the application of *Commissioner v. Court Holding Company*, 324 U.S. 31, to this case is wholly erroneous.

We submit that the position of the Strong Trust should not be ignored and, if it is not ignored, then the following statement by the court below is entirely correct: (R. 319)

> "Petitioner's first contention, if sustained, would carry the day and obviate the necessity of considering the errors assigned on the basis of the corporate reorganization statute, §§ 368(a)(1)(D) and (F). 26 USCA, §§ 368(a)(1)(D) and (F)."

2. Even if the sale to the Strong Trust is ignored, there was no reorganization between Reef Fields and Reef under sec. 368(a)(1)(D) and the holding of the Court of Appeals that there was is so erroneous that this Court should reject that application of sec. 368(a)(1)(D).

If the Strong Trust is ignored, the situation would be as follows:

(1) The Butler group formed Reef and transferred to it 3,832 shares of Reef Fields stock in payment of Reef's stock. The three main ones in the Butler group and their percentage ownership of the stocks were:

	Reef Fields	Reef
Butler	7.58%	28.98%
Miller	2.44	15.68
Lents	2.44	17.59
	14.18%	54.25% (R. 47, Ex. 47)

(2) Reef then bought all the assets of Reef Fields except $1,217,000 cash and gave Reef Fields its Notes as follows:

Series A	$1,093,500
Series C	2,310,500
Series D	924,200
Series B, D and F	574,800
	$4,903,000

(3) Reef Fields then dissolved and distributed the following to its stockholders in exchange for their stock in Reef Fields (none of the stockholders owning any notes, obligations or securities of Reef Fields except its stock):

	Favrot Group	Butler Group	Reef
Cash	$1,217,000		
A Notes		$1,093,500	
C Notes	1,217,000	$1,093,500	
E Notes	486,800	437,400	
B, D and F Notes			$574,800
	$2,920,800	$2,624,400	$574,800

Reef Fields got only notes of Reef, it distributed no stock of Reef qualifying under section 354 or 355 or 356, its stockholders surrendered no securities of any principal amount of Reef Fields in exchange for the notes of Reef, and the latter did not acquire substantially all the properties of Reef Fields as the latter retained $1,217,000 in cash which it paid out to the Favort group.

Sections 368(a)(1)(D) and 354 referred to therein of the 1954 Code correspond to sections 112(g) and 112(b)(3) of the 1939 Code. The 1954 Code made extensive changes in those sections and we set them out in parallel columns so that these changes may be readily apparent:

1939 Code

SEC. 112(g) DEFINITION OF REORGANIZATION.—As used in this section (other than subsection (b) (1) and subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, * * *.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(b) EXCHANGES SOLELY IN KIND.—

1954 Code

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combinations thereof, is in control of the corporation to which the assets are transferred; *but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;* * * * (Emphasis added)

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(3) STOCK FOR STOCK ON REORGANIZATION. — No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorgnization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) the corporation to which the assets are trans-

> ferred acquires substantially all of the assets of the transferor of such assets; and
>
> (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Before discussing the specific changes made by the 1954 Code, we call attention to the fact that this Court in *LeTulle v. Scofield,* 308 U.S. 415, and *Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue,* 287 U.S. 462 (in which it specifically approved *Cortlandt Specialty Co. v. Commissioner of Internal Revenue,* 60 F.2d 937) and other cases, has held that there is no reorganization where one company acquires another company simply for cash or bonds or notes for such transactions are sales and were never intended to come within the spirit or meaning of reorganizations.

We specifically call to the attention of this Court that section 368(a)(1)(D) of the 1954 Code is exactly like section 112(g)(1)(D) of the 1939 Code except that the 1954 Code added the following specific provision:

> *"but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355 or 356;"* (Emphasis added)

The Tax Court completely ignored this provision simply in reliance on *Commissioner v. Morgan,* 288 F.2d 676 (CA

3, 1961), reversing 33 T.C. 30, and *James Armour, Inc.*, 43 T.C. 295 (1964). Before taking those cases up, we wish to point out that in its report to the Senate on the 1954 Code the Senate Committee on Finance stated on page 274 in reference to this addition to (D):

> "Subparagraph (D) also *explicity* states that a transaction of the type described is only to be considered a reorganization when the stock and securites of the transferee corporation or corporations are distributed to the shareholders and security holders under the terms of section 354, 355, or 356. However, where there is no such distribution, the transaction may, nevertheless, result in nonrecognition of gain or loss to the transferor corporation under the terms of section 351." (Emphasis added)

This whole line of argument about disregarding this provision in (D) arose from the decision of the Court of Appeals for the Third Circuit in *Commissioner v. Morgan*, 288 F.2d 676, in which two corporations were involved that were owned substantially by the same parties. The case arose under section 112(c)(2) of the 1939 Code and no stock was issued or distributed. The decision was by two out of the three judges on that Court of Appeals and the majority based its decision on the following flat statement at 288 F.2d 680:

> "Here, the issuance of new stock would have been a meaningless gesture since the stock the taxpayer already held represented the total value of all the assets except for the boot."

Judge Hastie strongly dissented, saying at 288 F.2d 681:

> "It is argued, however, that in this case no transfer of stock of a corporation to the taxpayer is the legal

> equivalent of an actual stock transfer merely because the taxpayer already was and long had been sole stockholder of that corporation. I can see no logical basis for thus finding an exchange of stock within the statutory requirement without any demonstration that something happened in this case which was equivalent to a transfer of stock to the taxpayer."

On the strength of the *Morgan* case the Tax Court made the same holding in *James Armour, Inc.*, 43 T.C. 295 under section 368(a)(1)(D).

We submit this Court should pass upon the question as to whether that express requirement that stock be distributed should be completely ignored.

In addition, that clause in section 368(a)(1)(D) provides that there must be a distribution of stock or securities in a transaction *qualifying under section 354, 355 or 356*. Obviously this transaction does not come within section 355 or 356. As pointed out above, section 354 of the 1954 Code corresponds to section 112(f)(3) of the 1939 Code but section 354 of the 1954 Code added certain limitations. Section 354(a)(2) expressly provides that section 354 shall not apply if the principal amount of any securities received in a distribution exceeds the principal amount of any such securities surrendered or if any securities are received and no securities surrendered. In this case all the stockholders of Reef Fields could be considered to have received notes of Reef but they surrendered no notes or anything of Reef Fields except stock. This Court should state whether the limitation in section 354(a)(2) is to be applied or not.

In addition, section 354(b) specifically provides that an exchange under section 368(a)(1)(D) shall not qualify under section 354 unless the acquiring corporation acquires

substantially all of the assets of the transferor. In this case, a very substantial part of the assets of Reef Fields, namely, $1,217,000 in cash, was not acquired by Reef. We submit it can still not qualify as a reorganization under section 368(a)(1)(D).

But the Tax Court and the Court of Appeals stressed the point that Reef took over all the operating properties, all the employees, the retirement plan and all other matters of Reef Fields, and, therefore, they said this was a reorganization. Anyone with any experience in the business world knows that, where one corporation buys out another corporation lock, stock and barrel for cash, it takes over all of its operating assets, all of its personnel, all of its retirement and pension plans and all other arrangements with its employees, but this did not keep this Court from holding that such a purchase for cash is not a reorganization.

3. Even if the sale to the Strong Trust is ignored, the Tax Court and the Court of Appeals were clearly wrong in holding that the Series A to F Notes of Reef were not notes but were stock and should be considered as stock for reorganization and all other purposes and the payments of the interest thereon were not deductible as interest. We cannot understand the reasoning of the Tax Court or of the Court of Appeals. The latter relied solely on the reasoning of the Tax Court and we refer to its line of reasoning. (R. 283-285). In substance it said that these notes were subordinate to the lien of the life insurance company and that at $37,500 a month the life insurance company note would not be paid until November 1, 1965, and then it would take 3 years to pay the Series A and B Notes and an additional 5-1/2 years to pay the C and D Notes. The court then said:

> "For Reef to pay off the Series A, B, C, and D Notes at the rate of $37,500 per month, would require over 15 years from the date of their issuance. In considering the extended period over which the notes are payable, consideration of the nature of Reef's business is appropriate. Reef is in an extractive industry limited by its casinghead gas reserves and contracts. While these Series A, B, C, and D Notes were secured by second and third mortgages, the capital they represent was at the risk of the business. These notes were issued for the operating assets of the business in effect to the continuing corporate shareholders in a reorganization under section 368(a)(1)(D). This case presents not the ordinary question of 'thin incorporation' but rather the question of whether the amounts denominated as debt by the continuing shareholders in a reorganized corporation are loans or venture capital."

Such a holding is in conflict with the decisions of this Court and of other courts of appeals and we will refer only to this Court's decisions in *Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue,* 287 U.S. 462 and *LeTulle v. Scofield,* 308 U.S. 415. In the *LeTulle* case, the bonds were payable over a period of 11 years with the provision that the only remedy of the selling company, if the bonds were defaulted, was to take back the property sold. This Court held, nevertheless, that the term of the obligations was immaterial and the fact that the selling company could go only against the property sold would not change its status from that of a creditor to one having a stock interest. We quote the following at 308 U.S. 420-421:

> "*We are of opinion that the term of the obligation is not material.* Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee;

> and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute." (Emphasis added)

As pointed out above, the Reef notes provided that the interest should be payable semi-annually and, if any installment were not paid, the notes could be declared due immediately and the lien securing them could be foreclosed. Is this like stock? Furthermore, the fact that these notes were subordinate to the insurance company loan is not material. There are billions and billions of mortgages outstanding by corporations and, if this rule announced by the courts below were valid, no notes of any of those corporations subject to the lien of those mortgages would be indebtedness but all of them would be stock.

In reference to the statement that Reef is in an extractive industry limited by its casinghead gas reserves and contracts, there is not a line of evidence to support such a statement. Reef owns an interest in a gasoline extraction plant in west Texas through which casinghead gas from oil wells is run and casinghead gasoline, butane and other products are extracted. This plant was built in 1952 and on the trial of the case in April, 1964, the evidence showed it was still operating and the Government knows that it is still operating now and will be for many, many years as it extends its gathering lines from field to field in west Texas. If such a reasoning of the Tax Court were sound, then every note of any oil company that is in the "extractive industry" would be stock and not notes.

In addition, the facts show, as stated above, that on the trial of the case in April, 1964, just five years after the

purchase on February 28, 1959, by Reef, the latter had paid off the A Notes totaling $1,093,500, $805,500 of the C Notes and the B and D Notes totalling $479,000.

We may point out that this Court had before it in 1965 *Commissioner of Internal Revenue v. Brown*, 380 U.S. 563, in which the notes involved were payable purely out of future profits of the business and there was no personal liability on the part of the Foundation that executed the notes. This Court, nevertheless, held that they were "indebtedness."

4. The holding of the Court of Appeals that there was a reorganization under section 368(a)(1)(F) reading

> "(F) A mere change in identity, form or place of organization, however effected"

is directly contrary to this Court's holding in *Helvering v. Southwest Consolidated Corporation*, 315 U.S. 194, and that of the Tax Court in *Joseph C. Gallagher*, 39 T.C. 144, and the holding in *Moline Properties, Inc. v. C.I.R.*, 319 U.S. 436, and *National Carbide Corporation v. C.I.R.*, 336 U.S. 422, that the separate existence of corporations may not be ignored. In the *Southwest Consolidated Corporation* case, supra, this Court said in reference to this (F), which was at that time (E),

> "And a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form or place of organization' within the meaning of clause E."

The Tax Court in *Joseph C. Gallagher*, 39 T.C. 144, said, after referring to *Southwest Consolidated Corporation*:

> "And the shift that occurred in the proprietary interest of the two corporations was hardly the 'mere

change in identity, form or place of organization' required by subsection (F)."

In this case the Favrot group, owning about 50% of the stock of Reef Fields, wholly ceased to own stock in Reef and the individuals Butler, Miller and Lents became the owners of 54.25% of the stock of Reef whereas they had owned only 14.18% of the stock of Reef Fields. All the judges of the Tax Court and Judge Bell in his dissent in the Court of Appeals held there was no reorganization under (F) as against Judges Rives and Fulton who held there was such a reorganization. We submit it is perfectly clear that this cannot be a reorganization under section 368(a)(1)(F).

The Court of Appeals in the case of *J. E. Davant and Kathryn Davant, et al v. Commissioner of Internal Revenue,* No. 22,835 on its docket, handed down its opinion on August 22, 1966, making a similar holding as to section 368(a)(1)(D) and (F) and we have filed a petition for certiorari in that case for the taxpayers, which case is No. 911 on the October term docket of this Court. That illustrates the extent to which such an erroneous holding by the court below can go unless corrected.

We call the Court's attention to the recent decision of the Court of Claims of October 14, 1966, in *Columbia Gas of Maryland, Inc. v. United States,* reported in 66-2 USTC ¶ 15,711, found in Commerce Clearing House, Federal Excise Tax Reporter, ¶ 15,711. Section 4301 of the Internal Revenue Code imposed a tax on the original issue of certificates of stock of a corporation but section 4382(b)(1)(D) provided such tax should not apply to

"(D) whereby a mere change in identity, form, or place of organization is effected."

This subparagraph (D) is exactly like subparagraph (F) in section 368(a)(1)(F). In that case a parent company owned two subsidiaries, one of which owned all the properties in Maryland and West Virginia. The parent company had that subsidiary convey the Maryland properties to the other subsidiary, Columbia Gas of Maryland, Inc., which issued its stock to the parent company. The Court of Claims held that this was not "a mere change in identity, form, or place of organization". The tax on the stock issue was payable. We attach as Appendix D a copy of the opinion of the Court of Claims.

That court referred to *Cabot Corporation v. United States,* 220 F.Supp. 261, affirmed by the First Circuit in *Cabot Corporation v. United States,* 326 F.2d 753. In that case the parent company owned 100% of the stock of two subsidiaries and 95% of the stock of a third corporation. All were merged into one new corporation and stock was issued to the parent corporation in proportion to its holdings and to the holders of 5% in the third corporation. The same exemption provided in section 4381(b)(1)(D) was involved and the courts held again thaat this was not a "mere change in identity, form, or place of organization". In view of this clear conflict this Court should pass upon the meaning of this subdivision (F).

We set forth in Appendix C hereto a history of the definition of reorganizations.

5. As we have shown that the notes of Reef must be considered as notes and not as stock, it is clear that the lower courts were entirely in error in refusing Reef the right to deduct as an expense the interest paid on these notes.

6. The lower court held that, since Reef Fields could have itself organized Reef and sold its properties to Reef

for its stock and notes and then distributed its stock and notes to its stockholders, the Court should hold that this was actually done. We submit that this is going far afield from the Internal Revenue Code and is contrary to the decisions of this Court that the Code must be construed in accordance with its words and its meaning must not be stretched in the manner followed by the courts below. *Commissioner v. Brown*, 380 U.S. 563; *Old Colony Railroad Co. v. C.I.R.*, 284 U.S. 552; *Helvering v. Hammel*, 311 U.S. 504;*Helvering v. Flaccus Leather Co.*, 313 U.S. 247; *Hanover Bank v. C.I.R.*, 369 U.S. 672; *Turnbow v. C.I.R.*, 368 U.S. 537, and many other cases.

7. If this Court should agree with petitioner that there was no reorganization, then it should hold that the lower courts were entirely in error in sustaining all the disallowances made by the Commissioner of Internal Revenue in his deficiency letters.

8. As pointed out above, the Commisisoner of Internal Revenue mailed two notices at the same time on December 21, 1962, under section 6212 of the Internal Revenue Code, one addressed to Reef Corporation covering the period from December 15, 1958, to June 30, 1959, and the other to Reef Corporation (Successor in name to Reef Fields Gasoline Corporation) covering the year from July 1, 1958 to June 30, 1959. As heretofore pointed out, Reef appealed in each case to the Tax Court within the time prescribed by section 6213(a). Section 6212(c) provides that, when one deficiency letter has been mailed and such an appeal to the Tax Court has been taken, no further deficiency letter may be mailed until the appeal is disposed of. In this case the Government could not tell which letter was mailed first but admitted that they were mailed simultaneously. The Tax Court dismissed the appeal on the letter addressed

to Reef Corporation (Successor in name to Reef Fields Gasoline Corporation). The Court of Appeals affirmed the Tax Court holding against Reef on the letter addressed to it and then held that the second letter addressed to it as successor was also valid. This Court should pass upon the question as to whether both deficiency letters are invalid, and, if it should hold that only one is valid, it should designate the valid letter. The present status of the case leaves the taxpayer in a wholly undeserved quandary. For example, the petitioner inadvertently omitted to ask the Court of Appeals to withhold the issuance of its mandate. Its mandate was therefore issued under its rules and the petitioner has now received an order from the Tax Court reciting that the mandate has been received and stating that it is:

> "ORDERED: That the parties submit memorandum in accordance with the Opinion and Judgment of the Court of Appeals, or otherwise move with respect to this case on or before Wednesday, March 1, 1967, at 10:00 a.m. in Courtroom No. 2, 12th and Constitution Avenue, N.W., Washington, D.C."

Fortunately, on application of the petitioner the Court of Appeals has recalled its mandate. However, if this Court does not grant this petition for writ of certiorari, petitioner will be faced with a similar order of the Tax Court and it will be in a quandary as to whether the Government can sustain both the additional assessment of $70,695.18 for the period from December 15, 1958, to June 30, 1959, under one letter and the other deficiency of $111,894.40 for the fiscal year from July 1, 1958, to June 30, 1959.

If this Court should hold that one or the other of said letters is valid, then it should hold that the action of the Court of Appeals in sustaining both letters is erroneous.

CONCLUSION

For the foregoing reasons, your petitioner respectfully prays that this petition for writ of certiorari be granted.

Respectfully submitted,

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APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

NO. 22,836

REEF CORPORATION, Petitioner-Respondent,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Petitioner.

(AND REVERSE TITLE)

Petitions for Review of Decision of the Tax Court of the *United States, (Texas Case)*.

(October 25, 1966.)

Before RIVES and BELL, Circuit Judges and FULTON, District Judge.

BELL, Circuit Judge: This appeal is from a decision of the Tax Court reported as *Reef Corporation v. Commissioner*, T.C. Memo. 1965-72 and CCH Dec. 27309(M).

It involves income taxes. Reef Corporation appeals from the disallowance of a stepped-up basis of depreciation, and of interest on corporate indebtedness. The Commissioner, by way of a cross-appeal, contends that the Tax Court erred in not holding that the transaction which is the subject matter of the litigation constituted a corporate reorganization under § 368(a)(1)(F) of the Internal Revenue Code of 1954, as amended. 26 USCA, § 368(a)(1)(F). Additional taxes would be due under such a holding. We affirm the Tax Court on the appeal and reverse on the cross-appeal.

The facts giving rise to the controversy must be stated in some detail to form a frame of reference for the questions to be decided. Reef Fields Gasoline Corporation (Reef Fields) was organized as a Texas Corporation on July 30, 1951 to operate a casinghead gas plant. It was formed by two groups of people, hereinafter known as the Butler group and the Favrot group. The Butler group operated the company. The Favrot group had no operational responsibilities. The Butler group owned 21,328 shares of the 40,800 outstanding shares of common stock in the corporation and the Favrot group owned the remaining 19,472 shares.

In 1958 the Butler group determined to buy out the Favrot group. After discussions between the groups, a plan was formulated whereby the stockholders of Reef Fields would approve a plan of liquidation whereunder Reef Fields would sell its operating assets to a new corporation to be formed in exchange for cash and notes of the new corporation. The Favrot group would receive cash and notes while the Butler group would receive only notes. The Butler group rejected this plan after seeking legal advise and learning that the trans-

action would result in the payment of taxes by them when they were in fact receiving no cash with which to pay the taxes.

An alternative plan was devised and executed. The Butler group formed Reef Corporation (new Reef) under the Delaware law on December 15, 1958. They received all of the common stock of new Reef in exchange for a portion of their stock in Reef Fields. On the same day Reef Fields contracted to sell its properties to new Reef for its notes. All of the stock in Reef Fields was to be sold to a third party who was, in turn, to carry out the sale of the assets of Reef Fields to new Reef. To accomplish this the Favrot group then sold all of its Reef Fields stock to the third party, George Strong, Trustee, a Houston attorney, taking his notes in exchange therefor. As part of the plan, these notes were to be repaid by Strong as payments were made to him by new Reef. The Favrot group also received cash from Strong which was made possible by a simultaneous loan to him from Reef Fields. The cash came from the proceeds of a long-term life insurance company loan which was made contemporaneously by Reef Fields and assumed at the end of the transaction by new Reef. Some of the proceeds of the loan were used to pay prior loans of Reef Fields. Next, the Butler group sold their remaining shares in Reef Fields to Strong in return for his notes. New Reef then sold its Reef Fields stock which had been obtained from the Butler group to Strong in return for the notes of Strong and this placed all of the stock of Reef Fields in Strong. The next step was the acquisition of Reef Fields assets by new Reef, and the assumption by new Reef of the liabilities of Reef Fields. New Reef issued its notes to represent its

indebtedness to Reef Fields. Reef Fields then distributed the notes received from new Reef together with cash on hand to Strong, its sole stockholder. Strong pledged the Reef Corporation notes to the Butler group, Favrot group and new Reef, respectively, pro rata for the stock sold to him and he was relieved of any liability on his personal notes. Reef Fields was dissolved on April 27, 1959. This plan was satisfactory to the Butler group because the taxes due on the sale of Reef Fields stock was payable on an installment basis as payment was received from Strong.

Strong had business connections with the Favrot group and received only nominal consideration for his services. His entire role was to execute one part in an overall plan to redeem the stock of the Favrot group to the end that sole control of the business of Reef Fields would be vested in the Butler group. The business which had been operated by Reef Fields until February 28, 1959 when its properties were formally transferred to new Reef continued to be operated without interruption by new Reef. The management and the employees were the same, and even the pension-trust and profit-sharing plans of Reef Fields were transferred to and adopted by new Reef.

Reef Fields, which filed its income tax returns on an accrual basis and whose fiscal year ran from July 1 to June 30, filed an income tax return for the short taxable period July 1, 1958 to the date of dissolution, April 27, 1959. It reported a non-taxable gain on the sale of its properties to new Reef and claimed a deduction for reincorporation expenses. The Commissioner disallowed the return on the basis that new Reef was the successor in name to Reef Fields and thus the return should have

been for the full fiscal year. This position, rejected by the Tax Court, was based on the premise that the transaction resulted in a reorganization under § 368(a)(1)(F).

Reef Corporation (new Reef), the petitioner, which had adopted the accrual method and the July 1 to June 30 fiscal year, filed an income tax return covering the short period December 15, 1958, the date of its incorporation, to June 30, 1959. The sum of $66,208.75 was deducted as interest payments on the new Reef notes payable to Strong for repayment to the Butler group. Depreciation was computed on the basis of the cost of the assets to new Reef and not on the basis of the cost of the assets to Reef Fields. The Tax Court disallowed the interest payments, and held that the depreciation basis was the cost of the assets in Reef Fields.

There are three assignments of error by petitioner. It is contended that the Tax Court erred in refusing to recognize the sale by the various Reef Fields stockholders to Strong; in concluding that the transaction in question was a reorganization under § 368(a)(1)(D) with the result that new Reef did not receive a stepped-up basis on the assets purchased from Reef Fields for depreciation purposes; and in disallowing the interest paid to Strong by new Reef to the extent that the payment covered interest due on Strong's notes to the Butler group for the reason that the sums on which the interest was paid constituted capital or an equity investment rather than debt.[1] The Commissioner contends on his

[1] In addition to the other errors assigned, petitioner claims that in any event it was entitled to deduct the interest payment differential between what Strong paid as interest on his notes given to new Reef for the Reef Fields stock, and what new Reef paid to Strong on its notes which had been given for the assets. The difference was one fourth of one

appeal that the Tax Court erred in holding that the transaction did not constitute a reorganization under § 368(a)(1)(F), and in thus holding that the notice of deficiency to petitioner as the successor in name to Reef Fields Gasoline Corporation for a full fiscal year was invalid.

I.

Petitioner's first contention, if sustained, would carry the day and obviate the necessity of considering the errors assigned on the basis of the corporate reorganization statute, §§ 368(a)(1)(D) and (F). 26 USCA, §§ 368(a)(1)(D) and (F). If the sale to Strong by the Reef Fields stockholders is considered bona fide for tax purposes, and the sales contract between the corporations disregarded, the subsequent sale to new Reef might result in new Reef being entitled to a stepped-up basis for depreciation. 26 USCA, §§ 167(f), 1011, 1012.

We affirm the holding of the Tax Court insofar as it disregarded the role of Strong without further discussion. He was a mere conduit in a preconceived and prearranged unified plan to redeem the stock of the Favrot group in Reef Fields. His activity was but a step in the plan. He carried out a sales contract already entered into between the corporations. He assumed

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per cent and amounted to $598.75 to Strong for the period under consideration. This differential is in the nature of a service charge by or payment to Strong but it is part and parcel of the method chosen for the purpose of redeeming the Favrot stock and attempting to obtain a stepped-up basis of depreciation and the Butler group interest deductions. As will be seen in our further discussion, the role of Strong is being disregarded for tax purposes. It follows that the interest differential paid to Strong was not deductible.

no risk, incurred no personal liability, paid no expenses and obtained only bare legal title to the stock. There was an insufficient shifting of economic interests to Strong. It is settled that under such circumstances substance must be given effect over form for federal tax purposes. The holding of the Tax Court in this regard was not clearly erroneous. *Cf. Commissioner v. Court Holding Company,* 1945, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981; *Hindes v. United States,* 5 Cir., 1964, 326 F.2d 150; *United States v. General Geophysical Company,* 5 Cir., 1961, 296 F.2d 86; *Pebble Springs Distilling Company v. Commissioner,* 7 Cir., 1956, 231 F.2d 288. And see *Davant v. Commissioner,* 5 Cir., 1966, ... F.2d ...., decided this date, where we disregarded a sale to a third party brought in merely to serve as a conduit between two corporations having the same stockholders in the sale of assets by one to the other.

New Reef places primary reliance on the case of *Commissioner v. Brown,* 1965, 380 U.S. 563, 85 S.Ct. 1162, 14 L.Ed.2d 75. That case, however, is distinguishable. There was arm's length bargaining by the intermediate purchaser in that transaction, here there was not; the intermediate purchaser there acquired unfettered ownership and here Strong did not. Strong was in effect acting to service a contract rather than as a purchaser.

II.

This brings us to the contention of petitioner that the Tax Court erred on the depreciation question in holding that the transaction resulted in a corporate reorgani-

zation under § 368(a)(1)(D).[2] In general the reorganization sections of the Code, §§ 351 through 381, are designed to permit certain corporate changes and adjustments to be made without tax consequences to the participating corporation or corporations or their shareholders. The congressional policy is that while such transactions may produce changes in the conduct of the business enterprise or in ownership, these changes are not sufficiently significant to warrant taxing the gain or allowing the loss which comes about by reason of the change. Here, the transfer of assets from Reef Fields to new Reef was non-recognizable for the purposes of taxation. On the other hand, a corollary to non-recognition of gain or loss under this policy requires the carryover of the basis of corporate assets. This insures that any gain or loss realized but not recognized will not escape taxation but is simply deferred.

Petitioner here contends that the old asset basis for purposes of depreciation should give way to a stepped-up

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[2] § 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) **Reorganization.—**

(1) **In general.**—For purposes of parts I and II and this part, the term "reorganization" means—

* * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

basis computed on the cost of the assets to new Reef. Section 362(b) of the Code, 26 USCA, § 362(b), requires that petitioner's basis in the assets, if this was a reorganization, shall be the same as their basis in the hands of Reef Fields. The Tax Court was of the view that the transaction between Reef Fields, Strong, and new Reef meets the definition of a reorganization set out in § 368(a)(1)(D).

The statute first requires a transfer by Reef Fields of all or a part of its assets to new Reef. This condition was met. The statute requires that immediately after the transfer one or more of the shareholders in Reef Fields, who were shareholders immediately before the transfer, be in control of new Reef. The Butler group was in control of new Reef. However, unless Strong is to be ignored, they were not shareholders immediately before the transfer of the assets because their stock had been conveyed to Strong in part and to new Reef in part. We conclude, as did the Tax Court, that Strong is to be disregarded for the purposes of this statute. The same reasoning applied in Part I of this opinion for not finding a bona fide sale applies equally here. Strong was a mere conduit for carrying out a prearranged plan and his role is of no significance in determining the tax consequences of the transaction.

But this is not the end of the matter. The statute also provides that pursuant to the plan of reorganization, and there was definitely a plan here, the stock or securities of the corporation to which the assets are transferred (new Reef) be distributed in a transaction which qualifies under § 354, 355, or 356 of the Code.

26 USCA, §§ 354, 355, 356. Only § 354[3] is pertinent here. Section 356 is the "boot" section applicable to either a § 354 or a § 355 situation.

Section 354(a)(1) requires the exchange of stock or securities in Reef Fields for stock or securities in new Reef. Disregarding Strong, here the Butler group exchanged some of their Reef Fields stock for all of the new Reef stock and the balance of their Reef Fields stock for new Reef securities (notes). Thus the Butler group has complied with this requirement. The Favrot group also complied by transferring their stock for new Reef notes via Strong.

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[3] SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) **General Rule.—**

(1) **In General.**—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) **Limitations.**—Paragraph (1) shall not apply if—

* * *

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(3) Cross reference.—

* * *

(b) **Exception.—**

(1) **In general.**—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

We must also find compliance with § 354(b)(1)(A) and (B). Subsection (A) requires that new Reef must have acquired substantially all of the assets of Reef Fields and the Tax Court found this to be the fact. Petitioner urges that $1,217,000 in cash was distributed to the Favrot group and therefore "substantially all of the assets" of Reef Fields were not transferred to new Reef. However, eliminating this cash, approximately eighty per cent of the assets of Reef Fields were transferred to new Reef and this is a sufficient basis for the finding by the Tax Court.

Subsection (B) requires that the stock, securities or other properties received by Reef Fields must have been distributed pursuant to the plan of reorganization. This requirement was also met. The notes of new Reef were received by Reef Fields and distributed by Reef Fields to its shareholders via Strong. Here again we disregard Strong's participation for tax purposes. The statute cannot be avoided by such a strawman procedure. We read subsection (B) as requiring that whatever is received by Reef Fields, stock, securities and property, be distributed. Only securities were received and they were indeed distributed.

These statutory tests make redundant two general requirements which must be present if the reorganization statutes are to be applied. There must be continuity of interest between Reef Fields and new Reef. *Cortland Specialty Co. v. Commissioner,* 2 Cir., 1932, 60 F.2d 937; and also a continuity of business enterprise between the two. *Becher v. Commissioner,* 2 Cir., 1955, 221 F.2d 252. The continuity of interest was present here through the Butler group, and the continuity of business enterprise was present since new Reef carried on the same business

as Reef Fields. See Mertens, Law of Federal Income Taxation, §§ 20.55, 20.91.

This was clearly a corporate reorganization within the meaning of § 368(a)(1)(D) and, accordingly pursuant to § 362(b), new Reef's basis in the corporate assets is the same as it was in the hands of Reef Fields. The Tax Court was correct in so holding.

III.

The last contention of petitioner to be considered is whether the Tax Court erred in sustaining the disallowance by the Commissioner of the interest paid by new Reef to Strong and, in turn, by Strong to the Butler group on the notes received for the Reef Fields assets. These assets were sold to new Reef by Reef Fields and the notes received by Strong for the Butler group represented that portion of the purchase price which their shares in Reef Fields bore to the whole purchase price. The transaction began with the Butler group owning 21,328 shares and the Favrot group owning 19,472 shares of the 40,800 shares of Reef Fields common stock outstanding. The Butler group transferred 3,832 of its shares in Reef Fields to new Reef for all of the stock in new Reef, thus leaving 17,496 shares of the Reef Fields stock in the Butler group.

The sum of these transactions is that new Reef had a capitalization of $100,000 represented by the 3,832 shares of Reef Fields stock. Again disregarding the role of Strong, Reef Fields issued $2,920,000 in notes and cash to the Favrot group for its proprietary interest, 19,472 shares. New Reef notes were issued to the Butler group totalling $2,624,400 for their 17,496 shares of stock in Reef Fields.

The result was that the stock of the Favrot group was redeemed; and 17,496 shares of the total of 21,328 shares owned by the Butler group was converted into debt through the medium of the new Reef notes. This too was a redemption albeit a delayed redemption. The debt was then set up on a basis whereby new Reef would deduct the interest paid to the Butler group on the debt and this, to us, is a transparent dividend.

In addition to the drastic reduction in capital which came about in the transmutation between Reef Fields and new Reef, there is one other factor which strongly indicates that the sums due the Butler group on the new Reef notes was intended to serve as risk capital. The Favrot group received a large payment in cash, in fact approximately forty two percent of the value of their stock. This came from a life insurance company loan. The Butler group received no cash. All of the notes issued by new Reef for the assets were subordinated to the $3,000,000 loan due the life insurance company. Except in the event of excess earnings, no payments would be made on the notes until the large insurance loan was paid off nearly seven years later. The notes would then be paid off on an installment basis over a period of several additional years. Thus the new Reef notes due the Butler group, sole owners of new Reef, represented debt to be used at the risk of the business in that it was deferred to the business.

These facts are sufficient to sustain the Tax Court. In addition to the Favrot redemption, we have, in effect, a substantial redemption of the Butler interest in Reef Fields through a debt process. But the debt, under the circumstances, is risk capital and petitioner may not deduct the interest payments received by those furnish-

ing the risk capital. See *Montclair, Inc. v. Commissioner*, 5 Cir., 1963, 318 F.2d 38 and *cf. Rowan v. United States*, 5 Cir., 1955, 219 F.2d 51. See also Mertens, Law of Federal Income Taxation § 26.10c.

Starting with the business purpose of redeeming the stock of the Favrot group in Reef Fields, we end up with a step transaction whereby some hope was at least engendered of obtaining a stepped-up depreciation basis and interest deduction in lieu of dividends. We have a business purpose combined with an impermissible contrivance to avoid taxes. *Cf. Gregory v. Helvring*, 1935, 293 U.S. 365, 55 S.Ct. 266, 79 L.Ed. 596. There is no merit in the contentions of petitioner.

IV.

The court is unanimous with respect to what has heretofore been said. Still left for consideration, however, is the cross-appeal of the Commissioner. It is his contention that the Tax Court erred in failing to hold that the transaction resulted in a corporate reorganization within the scope of § 368(a)(1)(F).[4] His position is that no more took place than a mere change in identity, form, or place of organization of Reef Fields. Judges Rives and Fulton are of the view that this contention should be sustained. This means that the notice of deficiency sent to petitioner as the successor in name

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[4] § 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) Reorganization.—

(1) **In general.**—For purposes of parts I and II and this part, the term "reorganization" means—

* * *

(F) a mere change in identity, form, or place of organization, however effected.

to Reef Fields will be validated and a remand will be necessary so that the Tax Court may consider the Commissioner's position under that deficiency notice.

The Commissioner sent two statutory notes of deficiency as a protective measure. One notice, addressed to "Reef Corporation (successor in name to Reef Fields Corporation)", was based on the position that new Reef, although a new corporate entity, was the same taxable entity as Reef Fields. The deficiency under this notice was claimed to be $111,894.40. The other notice, addressed to "Reef Corporation", treated new Reef as a new taxable entity to file a return covering the short taxable period but the depreciation and interest deductions were disallowed, as stated, and the additional tax due was claimed to be $70,695.18.

The Tax Court rejected the Commissioner's position with respect to § 368(a)(1)(F), and thus the deficiency notice to petitioner as successor in name to Reef Fields was invalid. As noted, the Tax Court did adopt the Commissioner's alternative position that the transaction resulted in a corporate reorganization under § 368(a)(1)(D), and concluded that the assets transferred by Reef Fields to new Reef had a substituted basis for depreciation and not a stepped-up basis.

The reasoning which supports the conclusion of Judges Rives and Fulton that this is a § 368(a)(1)(F) reorganization follows.

In concluding that the instant case was not a type (F) reorganization, the Tax Court interpreted the Supreme Court's last sentence in *Helvering v. Southwest Consolidated Corporation*, 1942, 315 U.S. 194, 202, 203,[5] as

[5] Hereafter cited as Southwest Consolidated.

holding § 368(a)(1)(F) is "inapplicable when there is a shift in proprietary interest." *Southwest Consolidated* was decided under the 1939 Internal Revenue Code, and we think that the complete revision of the Code in 1954 compels a different result under the instant circumstances from that reached in *Southwest Consolidated*. Further, this case is distinguishable on its facts from *Southwest Consolidated*.

A.

The intricate and confusing facts of this case have been carefully explained. Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48% of the stock in Reef Fields had their stockholdings completely redeemed. Second, new Reef was formed and the assets of Reef Fields were transferred to new Reef. The business enterprise continued without interruption during both the redemption and the change in corporate vehicles.

Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a standard, these two elements were functionally unrelated. Reef Fields could have completely redeemed the stock of 48% of its shareholders without changing the state of its incorporation. A complete redemption is not a characteristic of a reorganization. Congress clearly indicated this when it defined reorganization in section 368. Section 368 (a)(1)(A) speaks of a "merger or consolidation" which looks to the joining of two or more corporations. Section 368 (a)(1)(B) and (C) look to one corporation acquiring the assets of another or control of another corporation solely for its voting stock. Section 368 (a)(1)(D) looks to the

consolidation of two or more corporations or the division of two or more going businesses into separate corporations. Only sections 368 (a) (1) (E) and (F) look to adjustments within a corporation. But none of these provisions focuses on a complete redemption as a characteristic of a reorganization. Congress did not have redemption of stock as a primary purpose of any of the forms of a reorganization. That subject came under consideration when it undertook to enact specific legislation on complete and partial redemptions, section 302.

The boot provision, section 356, is adequate to cover a complete redemption when it occurs incident to a reorganization whose primary purpose conforms to the intent of section 354 or 355. But section 356 was principally designed to cover dividends incident to a reorganization. When the primary characteristics of the reorganization conform to those described by 368 (a) (1) (F), we should parse the occurrences into their functional elements. The reorganizational characteristics present in the instant case do not conform to those generally intended to be covered by section 354 and therefore we should not be blinded by the 356 boot provision. To effectuate the intention of Congress manifested in the Code, we must separate this transaction into its two distinctly separate functional parts. The test of whether events should be viewed separately or together as part of a single plan is not temporal but is functional. See *Davant v. Commissioner*, 5 Cir. 1966, ... F.2d .... (slip opinion pp. 27-30). Applying this test to the instant case, it is clear that the redemption and the change of corporate vehicles must be viewed as separate and distinct occurrences. *Cf. Bazley v. Commissioner*, 1947, 331 U.S. 737.

B.

In 1954 Congress completely overhauled the sections of the Code detailing the tax consequences of many types of corporate transactions.[6] Grouped together by Congress were the sections dealing with corporate distributions and adjustments, including the sections dealing with partial liquidations, stock redemptions (complete or partial), and corporate reorganizations.[7] As we said in *Davant v. Com-*

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6 The House Report accompanying H.R. 8300, 1954 U.S. Code Cong. & Admn. News 4017, 4059, said:

> "Your committee has carefully considered existing law with respect to all of these corporate and intercorporate transactions. As a result your committee's bill represents a complete structural overhaul of existing law in this area. Your committee's bill has had three basic objectives. First, it has endeavored to make existing law more certain by redrafting existing provisions so as to clarify their meaning, and by supplying statutory provisions where none now exist. Second, your committee's bill is designed to provide for non-recognition of gain or loss in cases which involve a mere rearrangement of the corporate structure or other shifts in the form of the corporate enterprise which do not involve any distribution of corporate assets to shareholders. These provisions, like those in existing law, are designed to insure that the full tax will be imposed through the operation of the basis provisions when there is such a realization. Third, your committee's bill is designed to make impossible a number of tax avoidance devices which exist under the present statute and have received the sanction of court decisions."

While the Senate eliminated certain portions in the House bill, it still sought to tie corporate taxation to "substance" not "form." 1954 U.S. Code Cong. & Admn. News 4621, 4672-74; Conference Report, 1954 U.S. Code Cong. & Admn. News 5280, 5293-944, 5298-99.

7 Both the House and the Senate treated "Corporate Distributions and Adjustments" as a single integrated tax system designed to function as a unit. 1954 U.S. Code Cong. & Admn. News at 4020, 4058-71, 4624, 4672-89. Included among these provisions were sections 302, 354, 368, 381.

missioner, 5 Cir. 1966, ... F.2d .... at .... (slip opinion p. 8): "In order to effectuate the intent of Congress the dividend, liquidation, redemption, and reorganization sections of the Code must be examined and viewed as a functional whole."

Prior to 1954 Congress had not specifically provided for the tax treatment of partial liquidations or redemptions. This problem had been handled by judicial decisions which caused "considerable confusion" and in some cases resulted in "unwarranted" taxes and in others allowed taxpayers to "avoid" proper taxation.[8] To correct this situation, Congress enacted a comprehensive set of rules governing the complete and partial redemptions of a stockholder's interest in a corporation. Section 302.

In the instant case the only way to protect the statutory intent of Congress is to test the redemption of stock by the provisions of section 302. A similar result as to the stockholders comes from applying sections 368, 354 and 356. But this method may not always reach the same result and in the instant case would cause an improper result with regard to the corporation. Since the reorganization and the redemption are functionally unrelated in this case, the redemption should be tested by the standard Congress has laid down in section 302.

Prior to 1954 Congress had not specifically provided which tax attributes should be carried over to the surviving or new corporation remaining after a reorganization.[9] "These include such items as loss carry-overs, unamortized bond discounts, installment sales reporting, LIFO inven-

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[8] 1954 U.S. Code Cong. & Admn. News 4017 (House Rep.) at 4060. See similarly the Senate Report ibid at 4675.

[9] 1954 U.S. Code Cong. & Admn. News at 4066, 4683.

tory method, and earnings and profits."[10] These adjustments had been left to judicial interpretation. In addressing itself to this problem, the House Committee said (1954 U.S. Code Cong. & Admn. News at 4066):[11]

> "As a result, present practice rests on court-made law which is uncertain and frequently contradictory. Moreover, whether or not the carry-over is allowed should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization."

The Senate Committee explained that under the new section 381 (1954 U.S. Code Cong. & Admn. News at 4684):

> "Tax results of liquidations or reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of the two or more separate businesses into a unified business enterprise. At the same time the new provision makes it difficult to escape the tax consequences of the law by means of a legal artifice such as liquidation and reincorporation or merger into another corporation."

Thus, in 1954, in order to correct the existing problems created by unrealistic and conflicting judicial decisions, Congress enacted a comprehensive set of rules governing the carry-over of tax attributes from one corporation to another as a result of a reorganization. Section 381.

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10 1954 U.S. Code Cong. & Admn. News (Senate Rep.) at 4683. See similarly the House Report, ibid, at 4066.

11 See similarly 1954 U.S. Code Cong. & Admn. News (Senate Rep.) at 4683.

In section 381 Congress made a rational distinction between reorganizations that constitute a mere change in form and those that integrate two previously separate and independent enterprises. Where two or more separate businesses are unified into a single enterprise under a 368 (a) (1) (D), 354 reorganization, Congress recognized that the resulting new enterprise should be allowed to change certain of its accounting procedures. See for example section 381 (b). But Congress also realized that when the business enterprise is carried on as before, with no change in its substance, this is not a proper time to allow the business to change its accounting procedures. See for example 381 (b).[12] Thus for the first time, in 1954 it became important to determine whether a reorganization was considered a (D) type or an (F) type reorganization.[13]

Virtually all (F) reorganizations also qualify as (D) reorganizations.[14] When a transaction qualifies as both an (F) and a (D) reorganization, if the new entity were governed by the less stringent continuity rules of (D)

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12 Section 381 (b) excludes type (F) reorganizations from the liberal treatment accorded type (D) reorganizations.

13 Whether a reorganization is only a (D) type or also qualifies as an (F) type reorganization is also important in applying section 1244. Section 1244 (d)(2) applies different rules to an (F) type reorganization than are applied to an (A), a (C) or a (D) reorganization.

14 In its revision of the Code, the House Committee "deleted as unnecessary" section 368 (a)(1)(F). 1954 U.S. Code Cong. & Admn. News at 4253. The Senate Committee restored that provision (1954 U.S. Code Cong. & Admn. News (Senate Rep.) 4621, 4911), however, noting that "section 354 provides rules for exchanges by shareholders and security holders in reorganizations described in sections 368 (a)(1)(A), (B), (C), (E), and (F)." 1954 U.S. Code Cong. & Admn. News at 4903. Thus, the fact that the instant reorganization qualifies under 354 does not mean that it is not also an (F) type reorganization.

reorganizations, provided by section 381, the (F) rules would become a dead letter. The (F) rules are stricter than the (D) rules because a mere change of corporate charter or state of incorporation is not the proper occasion for wholesale accounting method changes that would not have been permitted if no reorganization had taken place.

Only those reorganizations which reflect a substantial change in the corporate operation should be viewed as *solely* (D) reorganizations qualifying for the more liberal rules. Where there is no substantial change in the corporate operation, (F) should be applied since it invokes the stricter rules.

In the instant case there has been no substantial change in the operation of the corporate business. It is carried on just as before but in a new corporate vehicle. This is not a 354 "integration of two or more separate businesses into a unified business enterprise," which Congress considered when it adopted the more liberal rules applicable to a (D) reorganization.

What characteristics of reorganization are present in this case? The only characteristics of a corporate reorganization are the changes in name and state of incorporation. Those are primarily the characteristics of an (F), not a (D), reorganization. The redemption is not a characteristic of a reorganization, as is demonstrated by the fact that a redemption standing alone would not allow a corporation to make wholesale changes in its method of accounting.

If a corporation did no more than completely redeem the stock interest belonging to 48% of its shareholders, it could not under the Code make wholesale accounting method changes. Likewise, if a corporation did no more

than change its name and state of incorporation, it could not under the Code make wholesale accounting method changes. Combining these two events, neither of which would be sufficient alone, will not permit a corporation to make wholesale accounting method changes. Nothing in the Internal Revenue Code of 1954 contemplates such a result.

Mr. Justice Holmes, sitting on circuit in *Johnson v. United States*, 1 Cir. 1908, 163 Fed. 30, 32, eloquently stated how we should interpret congressional enactments such as the sections here under discussion:

> "A statute may indicate or require as its justification a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind. The legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before."

The Tax Court's position might have more force if the change in proprietary interests were to new persons and less than 50% of the former stockholders' interest in the old corporation remained in the new corporation. Then the change begins to look like a sale of the assets to a new and legally separate entity followed by a bona fide

liquidation. Compare the discussion in Levin, *The Case for a Stepped Up Basis to the Transferee in Certain Reorganizations*, 17 Tax L.Rev. 511. But just how much of a complete redemption would be required to avoid the impact of section 381? Would 1% be enough? Sufficient continuity of interest has been found where 67% or 69% of the old corporation's stockholders control the new corporation. *Reilly Oil Co. v. Commissioner*, 5 Cir. 1951, 189 F.2d 382; *Western Mass. Theaters v. Commissioner*, 1 Cir. 1956, 236 F.2d 186. Changes of less than 50%, as we have here, or for that matter any change not sufficient to prevent the finding of a reorganization should not be sufficient to prevent the operation of section 381. The corporate enterprise went on as before, no new blood was injected and all that took place was a redemption followed by a change in name.

We hold, therefore, that the changes made in the Code in 1954 makes the *Southwest Consolidated* decision inapplicable here. We hold also that under the 1954 Code this transaction constituted both a 368 (a) (1) (D) and a 368 (a) (1) (F) reorganization.

C.

On its facts *Southwest Consolidated* does not apply to this case. If we view the instant case as involving two separate and independent occurrences, *Southwest Consolidated* would test only the reorganization aspects of the case.[15] *Southwest Consolidated* took up *seriatim* the dif-

[15] **Southwest Consolidated** would only apply to the change in name, not the redemption which would be tested under section 302. Interestingly, **Southwest Consolidated** also found that no 368 (a) (1) (D) reorganization had taken place. If strictly applied to this case, no (D) type reorganization would be

ferent definitions of a corporate reorganization under the 1939 Code. It dispatched the (F) type question in one sentence.

Southwest Consolidated involved the problems of an insolvency reorganization. The original corporation was hopelessly in debt and its creditors had, through judicial intervention, undertaken the task of reorganizing it. In simple terms, a new corporation was formed and the assets of the old corporation were transferred to the new corporation with the creditors becoming the stockholders. It was this shift in the proprietary interest from the stockholders to the creditors which the Supreme Court held sufficient to prevent a reorganization.

In holding that none of the reorganization provisions applied, the Court said (315 U.S. 194, at 202):

> "Indeed, clause C [presently 368 (a) (1) (C)] contemplates that the old corporation or its stockholders, rather than its creditors, shall be in the dominant position of "control' immediately after the transfer, and not excluded or relegated to a minority position. Plainly, the normal pattern of insolvency reorganization does not fit its requirements.
>
> "Clause D [presently 368 (a) (1) (E)]is likewise inapplicable. There was not that reshuffling of a capital structure, within the framework of an existing corporation, contemplated by the term 're-

present here. However, the facts of the instant case are so different from **Southwest Consolidated** that there is in the instant case a reorganization. That being true, we should go further and determine what type of reorganization best fits the facts of the instant case.

> capitalization.' And a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization' within the meaning of clause E [presently 368 (a) (1) (F)]."

Clearly, the Supreme Court viewed the sale of the old corporation's assets to a new corporation with different stockholders as a substantial change in "the ownership of the proprietary interest." With this there can be no dispute, but that is not our case. We do not have a shift in the ownership of the proprietary interest in the sense that the assets have been sold to entirely new stockholders. At best we have a complete redemption covered by section 302 which, like all redemptions, means the remaining stockholders have increased their proprietary interest.

For the foregoing reasons, we hold that *Southwest Consolidated* does not control this case and that this is a § 368 (a) (1) (F) reorganization.

Affirmed on the appeal; reversed on the cross-appeal; remanded for further consideration by the Tax Court not inconsistent with the reversal.

BELL, Circuit Judge, dissenting in part:

I respectfully dissent from Part IV of the majority opinion. I do not think that the transaction in question constituted a corporate reorganization within the meaning of § 368 (a) (1) (F). That section has been construed by the Supreme Court as being inapplicable where there is a shift in proprietary interest. *Helvering v. Southwest Consolidated Corporation*, 1942, 315 U.S. 194, 62 S.Ct. 546, 86 L.Ed. 789. 3 Mertens, Law of Federal Income

Taxation, § 20.94. Here there was a clear and substantial change in propriety interest. The Favrot group was eliminated.

This is to be distinguished from the situation where only minor and technical differences between the original and surviving corporation will justify classification as a reorganization under § 368(a)(1)(F). See, for example, *Davant v. Commissioner of Internal Revenue*, 5 Cir., 1966, ... F.2d ...., involving two corporations having precisely the same stockholders and propriety interests. The assets of one corporation were conveyed to the other. And the court held the result to be a § 368(a)(1)(F) corporate reorganization. The court concluded that whether the assets were held by one or the other corporations made no practical difference and that the shift of the assets between them in view of the complete identity of stockholders and their proprietary interest, resulted in a mere change in identity or form. There was a change in corporate vehicles but not in substance. *Cf. Pridemark, Inc. v. Commissioner*, 4 Cir., 1965, 345 F.2d 35, 42; and see "The Reincorporation Game: Have the Ground Rules Really Changed?", 77 Harv. L.Rev. 1218, 1248 (1964).

There is nothing in § 381 of the Code, 26 USCA, § 381, or elsewhere, to overrule the specific holding of *Helvering v. Southwest Consolidated Corporation, supra*, and it is our duty, as was the case with the Tax Court, to follow that decision in the absence of more specific congressional direction. My view is that this was not an appropriate case for the application of § 368(a)(1)(F).

United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1965

NO. 22,836

D. C. Docket Nos. 788-63 and 789-63

REEF CORPORATION, Petitioner-Respondent,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent-Petitioner,

(AND REVERSE TITLE)

Petitions for Review of Decision of the Tax Court of the United States (Texas Case).

Before RIVES and BELL, Circuit Judges and FULTON, District Judge.

JUDGMENT

This cause came on to be heard on the petition of Reef Corporation, for review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court on the appeal is affirmed, and reversed on the cross-appeal; and remanded for further consideration by the Tax Court not inconsistent with the reversal.

BELL, Circuit Judge, dissents in part.

October 25, 1966

Issued as Mandate:

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 22,836

REEF CORPORATION, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

(AND REVERSE TITLE)

Petitions for review of decision of the Tax Court of the United States

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(December 15, 1966)

ON PETITION FOR REHEARING

Before Rives and BELL, Circuit Judges and FULTON, District Judge.

PER CURIAM:

It is ORDERED that the petition for rehearing in the above entitled and numbered cause be, and the same is hereby DENIED.

APPENDIX B

STATUTES INVOLVED

SEC. 163. INTEREST.

(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * *

(c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies—

(1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) REDEMPTIONS TREATED AS EXCHANGES.—

(1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the

redemption is not essentially equivalent to a dividend.

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) GENERAL RULE.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

SEC. 362. BASIS TO CORPORATIONS.

(b) TRANSFERS TO CORPORATIONS.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATIONS.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately

after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

SEC. 453. INSTALLMENT METHOD.

* * *

(b) SALES OF REALTY AND CASUAL SALES OF PERSONALTY.—

(1) GENERAL RULE.—Income from—

(A) a sale or other disposition of real property, or

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000,

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) LIMITATION.—Paragraph (1) shall apply—

(A) In the case of a sale or other disposition during a taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition—

(i) there are no payments, or

(ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 per cent of the selling price.

(B) In the case of a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was (by reason of section 44 (b) of the Internal Revenue Code of 1939) returnable on the basis and in the manner prescribed in section 44(a) of such code.

SEC. 1201. ALTERNATIVE TAX.

* * *

(b) OTHER TAXPAYERS.—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

SEC. 6212. NOTICE OF DEFICIENCY.

(a) IN GENERAL.—If the Secretary or his delegate determines that there is a deficiency in respect of any tax imposed by subtitles A or B, he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail.

* * *

(c) FURTHER DEFICIENCY LETTERS RESTRICTED.—

(1) GENERAL RULE.—If the Secretary or his delegate has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the Secretary or his delegate shall have no right to determine any additional deficiency of income tax for the same taxable year, of gift tax for the same calendar year, or of estate tax in respect of the taxable estate of the same decedent, except in case of fraud, and except as provided in section 6214(a) (relating to assertion of greater deficiencies before the Tax Court), in section 6213(b)(1) (relating to mathematical errors), or in section 6861(c) (relating to the making of jeopardy assessments).

SEC. 6213. RESTRICTIONS APPLICABLE TO DEFICIENCIES; PETITION TO TAX COURT.

(a) TIME FOR FILING PETITION AND RESTRICTION ON ASSESSMENT. — Within 90

days, or 150 days if the notice is addressed to a person outside the States of the Union and the District of Columbia, after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A or B and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court.

APPENDIX C

HISTORY OF DEFINITION OF REORGANIZATION

The Revenue Act of 1918 simply had Sec. 202(b) as follows:

> "SEC. 202. (b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged."

The Revenue Act of 1921 had Sec. 202(c)(2) as follows:

> "Sec. 202. (c) (2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word 'reorganization,' as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or, of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected);"

The Revenue Act of 1924 had Sec. 203 (h):

"SEC. 203 (h) As used in this section and sections 201 and 204—

"(1) The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected."

The Revenue Act of 1934 had Sec. 112 (g) (1):

"SEC. 112. (g) (1) The term 'reorganization' means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place or organization, however effected."

Sec. 112(g) of the Internal Revenue Code of 1939 was exactly the same as the same section in the 1936 Revenue Act.

Sec. 368(a)(1) of the Internal Revenue Code of 1954 was as follows:

"SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term 'reorganization' means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded.

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected."

APPENDIX D

COLUMBIA GAS OF MARYLAND, INC. AND CUMBERLAND AND ALLEGHENY GAS COMPANY v. THE UNITED STATES.

U. S. COURT OF CLAIMS, No. 415-64, 10/14/66.

Documentary stamp tax: Exemptions: Corporate reorganizations: "Divisive" reorganization.—Where a parent gas company split up one of its subsidiaries into two subsidiary corporations, the "divisive" reorganization was not exempt from the stamp tax. Although there may have been no change in the proprietary interest, the Court found that the fractionation of a business into different corporate entities was more than a mere change in identity, form, or place of organization. One dissent. Back reference: ¶ 3419.40.

Edward S. Smith, John W. Avirett II, Mathias J. De Vito, William Anderson, Albert McBride, Jr., 900 First Nat'l Bank Bldg., Light & Redwood Sts., Baltimore, Md., for plaintiff. Knox Bemis, Mitchell Rogovin, Assistant Attorney General, Lyle M. Turner, Phillip R. Miller, Department of Justice, Washington, D. C. 20530, for defendant.

Before COWEN, Chief Judge, JONES, Senior Judge, LARAMORE, DAVIS and COLLINS, Judges.

On Plaintiffs' and Defendant's Motions for Summary Judgment

LARAMORE, Judge, delivered the opinion of the court: This case, now before us on cross-motions for summary judgment, presents an interesting question of the scope of

the exemption for transactions incident to a corporate reorganization from the documentary stamp tax provisions of the Internal Revenue Code of 1954, 26 U.S.C. ch. 34, §§4301-4384 (1964 Ed.). Plaintiffs are wholly-owned subsidiaries of the Columbia Gas System, Inc., a Delaware corporation registered as a holding company under the Public Utility Holding Company Act of 1935, 49 Stat. 803. Plaintiff, Cumberland and Allegheny Gas Company (Cumberland), is a West Virginia corporation which prior to January 1, 1961, owned and operated natural gas transmission and distribution facilities in the states of West Virginia and Maryland. Its intrastate distribution operations were regulated by the public service commissions of the interested states. The interstate transmission activity was subject to the Federal Power Commission's jurisdicion. This regulatory situation was not ideal because the commissions used somewhat different rate-making formulas. The technical aspects of the interaction of the different formulas are not germane to this case; it is sufficient to say that Cumberland's management concluded that the rate structures of the West Virginia and Maryland gas distribution businesses would be more favorable if they were placed in separate corporate entities. To this end, Cumberland as a first step created the other plaintiff, Columbia Gas of Maryland, Inc., a Delaware corporation, on July 1, 1958. Four months later, on November 1, Columbia Gas System the parent, Cumberland the subsidiary, and Columbia Gas of Maryland the then sub-subsidiary shell corporation, agreed to "split-off" the gas distribution business in the state of Maryland by having Cumberland transfer to Columbia Gas of Maryland the tangible and intangible assets relating to that business. This took place on January 1, 1961. As an additional part of the agreement, and

in consideration of the transfer of assets, Columbia Gas of Maryland issued 76,194 shares of $25 par capital stock, six percent demand notes, and installment promissory notes. This package of securities issued directly to Columbia Gas System and not to Cumberland, the transferor of the assets. Complete symmetry was provided by the simultaneous cancellation of 76,194 shares of Cumberland $25 par capital stock, six percent demand notes, and installment promissory notes (in all respects equivalent to the shares and notes issued by Columbia Gas of Maryland) owned by the parent Columbia Gas System. Since January 1, 1961, then, Columbia Gas System has been the parent of both Cumberland and Columbia Gas of Maryland. The intrastate distribution business of the former has been regulated by the West Virginia Public Service Commission, that of the latter by the Maryland Public Service Commision.

In connection with the above transactions, plaintiffs made the following purchases of Federal documentary stamps which are issued pursuant to the documentary stamp tax provisions of the Internal Revenue Code of 1954. Columbia Gas of Maryland paid $1,905 under the capital stock original issue tax provision for stamps to be affixed to the 76,194 shares of new capital stock, §4301.[1] It also paid $761.94 for stamps under the stock transfer tax provision on the theory that it had really originally issued the shares to Cumberland which in turn transferred them to Columbia Gas System, § 4321.[2] In addition, Cumberland

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[1] All section citations are to the Internal Revenue Code of 1954, 26 U.S.C. (1964 Ed.).

[2] In 1962, plaintiffs decided that this liability was properly Cumberland's as the constructive transferor, and accordingly arranged inter-company billing to have Cumberland reimburse Columbia Gas

purchased $19.80 of stamps for the tax on conveyances of real property, § 4361. Plaintiffs later determined they had mistakenly believed a tax was payable; they concluded and maintained here that the transactions should have been exempt from stamp taxes under section 4382(b) (1) (D). That provision reads as follows:

> § 4382. *Exemptions.*
>
> * * *
>
> (b) *Certain reorganizations, etc.*
>
> The taxes imposed by sections 4301, * * * 4321, * * * and 4361 shall not apply to—
>
> (1) *Corporate and railroad reorganization.*
>
> The issuance, transfer, or exchange of securities, or the making, delivery, or filing of conveyances, to make effective any plan of reorganization or adjustment—
>
> (D) whereby a mere change in identity, form, or place of organization is effected, * * *.

There is no question that the rearrangement of corporate structure constituted a reorganization—at least for income tax purposes. The Internal Revenue Service ruled, as the parent Columbia Gas System requested, that the transactions were comprehended by the term "reorganization" under section 368(a) (1) (D), which covers, *inter alia*, so-called "divisive reorganizations." The sole question is whether the reorganization also qualifies as one effecting

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of Maryland. In the petition, plaintiff Columbia Gas of Maryland claims the $761.94 refund; plaintiff Cumberland claims it alternatively if Columbia Gas of Maryland is not the proper party in interest.

"a mere change in identity, form, or place of organization" for purposes of the stamp tax law.

Subparagraph (D) of section 4382(b)(1) was added to the exemption provision by section 141 of the Excise Tax Technical Changes Act of 1958, 72 Stat. 1275, 1302. Prior to 1958, there was no comparable exemption, so the taxes here would clearly have been applicable. See *e.g.*, *American Mail Line, Ltd. v. United States* [52-1 USTC ¶ 9101], 121 Ct. Cl. 63, 101 F. Supp. 364 (1951). Our task is to determine how broad the additional exemption was intended to be. In proposing to the Senate that the exemption be added to the House bill, the Senate Committee on Finance stated the following:

> *(k) Exemption for corporate reorganizations involving a mere change in identity, etc.*
>
> Your committee has amended the proposed code section 4382 provided by the House bill to add a new exemption in the case of corporate reorganizations where the change is a mere change in identity, form, or place of organization, however effected. Such corporate reorganizations, along with certain other types of reorganizations, presently are free of income tax. Reorganizations involving a mere change in identity, form, or place of organization, represent merely a formalistic change and do not involve any shifts in ownership. For that reason, your committee has excluded such reorganizations from the issuance and transfer taxes on stocks and certificates of indebtedness as well as from the tax on the conveyance of real property. [S. Rep. No. 2090, 85th Cong., 2d Sess., p. 61 (1958), 1958-3 *Cum. Bull.* 584, 644.]

Reference to the freedom from income tax of corporate reorganizations involving "a mere change in identity, form, or place of organization, however effected" shows that the Committee had subparagraph (F) of section 368(a)(1) in mind. This provision, commonly known as the "F reorganization" provision, covers, at least, such transactions as a mere reincorporation in another state and a change of name effected by a merger into a newly created corporation. There is doubt whether it covers much more,[3] although in recent years, the government has attempted to give it greater vitality by using it as a weapon against a liquidation immediately followed by a reincorporation—a device which transforms dividends into capital gains.[4] A

[3] Section 368(a)(1)(F) is not explained in the regulations and it has received very little administrative or judicial attention. The commentators appear to be unanimous that it is the least significant of the reorganization provisions, and that it is doubtful what, if any, reorganizations would not be covered more specifically by another definition. See Bittker, **Federal Income Taxation of Corporations and Shareholders,** 359 (Federal Tax Press 1964); Paul, **Studies in Federal Taxation** 82 (3d Ser. 1940); 3 Mertens, **Law of Federal Income Taxation,** § 20.94; Surrey and Warren, **Federal Income Taxation** 1525 (1960 Ed. Foundation Press 1962). In 1954, the House proposed its repeal. It was retained, however, perhaps at the request of the tax bar, representatives of which noted that subparagraph (F) clearly covered reincorporations of all of a corporation's assets in another state or in the same state after expiration of a charter—transactions which might not meet the other definitions of a reorganization. See statements of the American Bar Association. Section of Taxation, and the Association of the Bar of the City of New York, Committee on Taxation. 1 **Hearings before the Senate Committee on Finance on the International Revenue Code of 1954,** 83d Cong., 2d Sess., pp. 403, 539 (1954).

[4] In **Pridemark, Inc. v. Commissioner** [65-1 USTC ¶ 9388], 345 F. 2d 35 (4th Cir. 1965), the taxpayer corporation, a dealer in prefabricated houses, sold its sales business assets to its supplier and formulated a plan of liquidation. Without more, this would entitle the corporation to tax-free treatment on the sale of the assets and the stockholders to capital gain treatment of any gain on the re-

possible explanation for its near vestigial status is that most tax-free reorganizations are more specifically provided for by the other subparagraphs of section 368(a)(1). Few taxpayers will proceed with a reorganization before obtaining a ruling and, as in the present case, the tendency is probably to limit the grounds for the request to the strongest and most specific—for example, Columbia Gas System asked for a ruling only under subparagraph (D) of section 368(a)(1). There was one recent case, however, in which the taxpayer did ask for a ruling not only under subparagraph (A) of section 368(a)(1), but also under subparagraph (F), and the Service ruled favorably on both. *Cabot Corporation v. United States* [63-2 USTC ¶15,512], 220 F. Supp. 261 (D. Mass. 1963), *aff'd per curiam*, [64-1 USTC ¶ 15,542] 326 F.2d 753 (1st Cir. 1964). *Cabot* demonstrates, although is was not there in issue, that it is possible for a reorganization to qualify both under subparagraph (F) as well as the more specific subparagraphs of section 368(a)(1). That is undisputed here.

For our purposes, *Cabot* is more important for interpreting the stamp tax exemption provision in issue here. We

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demption of their shares, §§ 331, 337. Before the corporation was dissolved, however, the shareholders decided to form a new corporation to sell prefabricated houses. The Commissioner asked the court to compress the transactions and consider them as a mere reincorporation within the section 368(a)(1)(F) definition. This would have the effect of transforming the liquidation distribution payments to the shareholders into dividends, taxable at ordinary income rates. Reversing the Tax Court, the Fourth Circuit found substance in the transactions and noted that there was much more than an uninterrupted continuation of the corporate enterprise. In a similar vein is **Hyman H. Berghash** [CCH Dec. 27,309(M)], 43 T.C. 743 (1965), **appeal pending** (2d Cir.), the difference being that a new owner was taken into the new corporation invoking the shift in ownership problem (discussed **infra**).

think it correctly interprets the stamp tax exemption by reading it narrowly. The facts there were the following: A company we shall call the X Corporation, a Massachusetts corporation, owned all the stock of two subsidiaries, the A Corporation and the B Corporation, likewise Massachusetts corporations. X Corporation also owned 95 percent of the stock of C Corporation, another Massachusetts corporation; the remaining 5 percent was owned by individual shareholders of X Corporation and a few outsiders. X Corporation had for some time been considering merging with its subsidiaries for business reasons but decided on an out-of-state reincorporation on its comptroller's advice that a Massachusetts tax could be thereby avoided. To effect this plan, Y Corporation was incorporated in Delaware, and X plus A, B, and C were thereafter merged into Y. Under the terms of the merger agreement, roughly 97 percent of the Y Corporation shares was issued in exchange for the outstanding shares of X Corporation. The remaining 3 percent was exchanged for the C Corporation stock held by the outsiders and by the individual who also owned X Corporation stock. Focusing on the language in the Senate Report that the exemption was to apply to "reorganizations involving a mere change in identity, form, or place of organization * * * [*which*] *do not involve any shifts in ownership* [emphasis added]," the District Court concluded that the slightest shift of proprietary interest was sufficient to disqualify the transaction. It noted that the former X shareholder owned a different percentage of the Y Corporation after the merger, and that "[s]uch a shift in substantive rights of ownership does not fall within the exemption provided by subparagraph D [of section 4382(b)(1)]." 220 F.Supp., at 265.

The plaintiffs have argued strenuously that *Cabot* supports their position because in the reorganization of the West Virginia and Maryland businesses, there was no shift in the ultimate ownership—*i.e.*, Columbia Gas System at all times owned all the equity. The defendant does not really contest the latter statement of fact; rather, it argues that the shift in ownership test does not stand alone but is simply a necessary ingredient of the requirement of "a mere change in identity, form, or place of organization." We agree with defendant that plaintiff is not entitled to the exemption simply on a showing that there was no shift in proprietary interest. It seems to us that the real question must be whether a divisive reorganization like the present can be considered "a mere change in identity, form, or place of organization, however effected" for stamp tax purposes notwithstanding the absence of a shift in ownership. The legislative history and *Cabot* do appear to establish a 100 percent continuity of interest requirement for the stamp tax exemption which may be more stringent than the case law and administrative practice relating to F reorganizations. See *San Joaquin Fruit & Inv. Co. v. Commissioner* [35-2 USTC ¶ 9401], 77 F.2d 723 (9th Cir. 1935), *rev'd on other grounds,* [36-1 USTC ¶ 9144] 297 U.S. 496 (1936); *Rev. Rul.* 54-193, 1954—1 *Cum. Bull.* 106; *Rev. Rul.* 61-156, 1961-2 *Cum. Bull.* 62. But see *Helvering v. Southwest Consolidated Corp.* [42-1 USTC ¶ 9248], 315 U. S. 194 (1942). However, the continuity of interest aspect is not very helpful here because it is really not the issue. Put simply, the difficulty in this case comes about because of the "divisive" aspect. Earlier, we questioned the breadth of the F reorganization provision to which Congress looked in adding the stamp tax exemption. We concluded that it is rather narrow, and we now read the history to the

exemption provision to further narrow or at least not widen the meaning of the F reorganization language. Read in this light, "a mere change in identity, form, or place of organization" has a very limited scope. Thus, we do not strain to attach great significance to each of the words in the phrase. It would, of course, be reasonable to attempt to give meaning to each word and thereby conclude that since Congress used the word, "form," it meant it to mean something other than "identity" or "place of organization." It would further be reasonable to conclude that the transfer of the Maryland gas distribution business from Cumberland to Columbia Gas of Maryland was a change in the "form" of doing business. But, although reasonable, we do not think Congress intended such an interpretation. Congress said a "mere" change in the statute, and the Committee report said "merely a formalistic change." We think the choice of "mere" indicates that the phrase should be given a unitary construction, and if that is the case, the divisive reorganization here falls outside the definition. It is too much of a stretch to say that the fractionation of a business into different corporate entities is comparable to a reincorporation or a change of name.

We find support in other areas of tax law for our holding that subparagraph (D) of the stamp tax exemption does not comprehend this kind of divisive reorganization. For example, Congress has had to enact provisions to deal with loss carryovers of parties to corporate reorganizations. In section 381(b), it is provided that except for F reorganizations, "[t]he taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer." The regulations state this idea in the affirmative regarding F reorganizations: "In the case of [an F reor-

ganization] * * * the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization." Treas. Reg. § 1.381(b)-1. In other words, the taxable year of the transferor really carries over to the acquiring corporation and net operating losses generated by the acquiring corporation after the transfer can be carried back to be used against prior earnings of the transferor. This is significant because the whole scheme suggests one surviving or successor corporation. In fact, the regulations are very clear that divisive reorganizations are not covered at all by section 381, making it appear that at least for purposes of this section, F reorganizations and divisive reorganizations are mutually exclusive. Treas. Reg. § 1.381(a)-1(b)(3). Much the same can be inferred from section 1244(d)(2), a provision enacted concurrently with section 4382(b)(1)(D) in 1958. Section 1244 gives favored ordinary loss treatment to losses realized on sales or exchanges of stock of qualifying small business corporations. In the "Special Rules" subsection (d), paragraph (2), it is provided that for certain purposes "a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor." As in section 381, the suggestion is that there will be one successor in an F reorganization. Surely sections 381 and 1244 do not dispose of our stamp tax exemption problem, but they do give an idea of the apparent scope of the F reorganization provision and of what Congress might have intended in using identical language in section 4382(b)(1)(D). Together, they make it very doubtful that a divisive reorganization could be an F reorganization for income tax purposes; we have already indicated that the stamp tax exemption is at least as narrow as the income tax provision.

To summarize, we think that Congress intended for the stamp tax exemption to be narrowly construed. We think this is borne out by a review of the F reorganization area, of the scanty 1958 legislative history, and of the *Cabot* case. The income tax provisions simply bolster this conclusion. Thus, reading the exemption narrowly, we conclude that plaintiffs' reorganization was more than "a mere change in identity, form, or place of organization" and not the kind of reorganization which Congress intended to exempt. Accordingly, plaintiffs' motion for summary judgment is denied, defendant's motion for summary judgment is granted, and the petition is dismissed.

Dissenting Opinion

COWEN, Chief Judge, dissenting: The construction of a statutory text, unaided by an unequivocal expression of the legislative intent or by crystallized judicial precedent, is a task seldom without its distinctions in preference—distinctions which more often than not are ones of emphasis rather than total disagreement. The stamp tax exemption now before us illustrates such differences of emphasis.

With the majority's premise that the exemption should be read narrowly, I concur. With its conclusion that the plaintiffs do not fall within the limited confines of the provision, I respectfully dissent.

Section 4382(b)(1)(D) of the Internal Revenue Code speaks in terms of "*any* plan of reorganization or adjustment * * * whereby a mere change in identity, form, or place of organization is effected."[1] I am unable to find any indication that Congress intended in that section to distinguish between divisive reorganization and the more familiar type of reincorporation. Cumberland's fractionation into separate corporate entities was prompted by legitimate business motives and effected no more than a change in its form and place of organization. Moreover, it is acknowledged that the rearrangement of the corporate structure qualified as a reorganization within the meaning of Section 368(a)(1)(D). If we adhere strictly to the wording of Section 4382(b)(1)(D), the reference therein to "any plan of reorganization" is certainly broad enough to encompass the arrangement undertaken by plaintiffs.

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[1] Emphasis added. The same language is contained in Treas. Regs. 47.4382-1(d)(iv).

The majority has alluded to the scanty legislative history and the paucity of decisional law on the issue presented in this case. Nevertheless, I cannot escape the conclusion that both of these aids to statutory construction favor the exemption claimed by plaintiffs. The last two sentences of the report of the Senate Committee on Finance (quoted in the majority opinion read:

> Reorganizations involving a mere change in identity, form, or place of organization, represent merely a formalistic change and do not involve any shifts in ownership. *For that reason* [emphasis supplied], your committee has excluded such reorganizations from the issuance and transfer taxes on stocks and certificates of indebtedness as well as from the tax on the conveyance of real property. [S. Rep. No. 2090, 85th Cong., 2d Sess., p. 61 (1958), 1958-3 *Cum. Bull.* 584, 644.]

The fact that "that reason" is singular suggests to me that the phrase "represent merely a formalistic change" is in apposition to the phrase "do not involve any shifts in ownership." If the two phrases were intended to have different meanings, I think the Senate Committee on Finance would have said "those reasons."

The only case which provides any real help on the question before us is *Cabot Corp. v. United States* [63-2 USTC ¶ 15,512], 220 F. Supp. 261, 265 (D. Mass. 1963), *aff'd per curiam*, [64-1 USTC ¶ 15,542] 326 F.2d 753 (1st Cir. 1964). The primary emphasis in that opinion can be summarized in the court's expression that " a shift in substantive rights of ownership does not fall within the exemption provided by subparagraph D."

Finally, according to *Revenue Ruling* 63-203, 1963-2 *Cum. Bull.* 580, 581:

> [Section 4382(b)(1)(D)] is not applicable to a change which involves *any* shift in ownership, because in any shift in ownership there is involved more than a mere change in identity, form, or place of organization.

Here, it is conceded that there has been no shift in the ownership of the businesses. Therefore, the legislative history, the *Cabot* case, and the cited revenue ruling provide persuasive authority for the proposition that plaintiffs are entitled to the claimed exemption.

On the admittedly close question to be decided, I cannot join the majority in the emphasis it has placed upon the term "mere" in the pertinent statute. Relying on the authorities cited above, I would stress the fact that Congress did not differentiate among the different types of corporate reorganizations when no shifts in ownership are involved. Accordingly, I would grant plaintiff's motion for summary judgment.

COLLINS, Judge, joins in the foregoing opinion.

APPENDIX E

DEFICIENCY LETTERS

Attached hereto are copies of the two deficiency letters of December 21, 1962, the one marked Exhibit A being to Reef Corporation and the one marked Exhibit B being to Reef Corporation (Successor in name to Reef Fields Gasoline Corporation). Copies of these were attached in this order to the petition in Docket No. 788-63 on the docket of the Tax Court, being that filed by Reef Corporation to the letter addressed simply to it. Copies of these letters were also attached, but in the reverse order, to the petition of Reef Corporation in No. 789-63 appealing from the letter addressed to Reef Corporation (Successor in name to Reef Fields Gasoline Corporation), which case the Tax Court dismissed because the letter addressed to it as such successor was invalid.

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
OFFICE OF REGIONAL COMMISSIONER
APPELLATE DIVISION
8031 FEDERAL BUILDING
515 RUSK AVENUE
HOUSTON 2, TEXAS

RECEIVED

CERTIFIED

IN REPLY REFER TO
Form L-21A
AP:H:WRT:90-D

EXHIBIT A

DEC 21 1962

TAXABLE YEAR	DEFICIENCY
12-15-58 to 6-30-59	$70,695.18

Reef Corporation
2138 Bank of the Southwest Building
Houston 2, Texas

Gentlemen:

In accordance with the provisions of existing internal revenue laws, notice is given that the determination of your income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount(s) shown above. The attached statement shows the computation of the deficiency or deficiencies.

IF YOU AGREE to this determination, please sign the enclosed agreement, Form 870, and return it promptly to this office. An addressed envelope is enclosed for this purpose. The signing and filing of this agreement will permit an early assessment of the deficiency or deficiencies and will limit the accumulation of interest.

IF YOU DO NOT AGREE, and do not sign and return the enclosed form, the deficiency or deficiencies will be assessed for collection, as required by law, upon the expiration of ninety days from the date of this letter, unless within that time you contest this determination in the Tax Court of the United States by filing a petition with that Court in accordance with its rules, a copy of which may be obtained by writing to its Clerk, Box 70, Washington 4, D. C.

Sincerely yours,

MORTIMER M. CAPLIN

Commissioner

By Roy W. Hann

Roy W. Hann
Associate Chief

Enclosures:
Statement
Agreement, Form 870
Addressed envelope

FORM L-21A (REV. 1-62)

STATEMENT

AP:H:WRT:90-D

Reef Corporation
2138 Bank of the Southwest Building
Houston 2, Texas

Summary of Tax Liability

Year	Deficiency
12-15-58 to 6-30-59	$70,695.18

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated July 14, 1961; to your protest executed September 19, 1961; and to the statements made at the conferences held on July 6, 1962 and September 25, 1962.

As of March 1, 1959, you acquired the assets of Reef Fields Gasoline Corporation, and for the period ending June 30, 1959 claimed depreciation on the basis of your alleged cost. It is determined your basis for depreciation and amortization is the same as that of Reef Fields Gasoline Corporation.

It is further determined the expenses in connection with your organization, and interest on the notes given as part of the alleged purchase price of the assets of Reef Fields Gasoline Corporation are nondeductible.

A copy of this letter and statement has been mailed to your representative, Mr. Homer L. Bruce, 1617 Esperson Building, Houston 2, Texas, in accordance with the authority contained in the power of attorney executed by you.

Reef Corporation - 2 - Taxable year Dec. 15, 1958 to June 30, 1959

Adjustments to Taxable Income

Taxable income as disclosed on return			$140,087.36
Unallowable deductions:			
(a) Depreciation		$91,060.70	
(b) Organization expense		88.52	
(c) Interest expense			
Series A and C notes	$65,610.00		
Series B and D notes	598.75	66,208.75	
Total		$157,357.97	
Additional deduction:			
(d) Amortization, Emergency Facilities		21,405.69	
Net addition			135,952.28
Taxable income as adjusted			$276,039.64

Explanation of Adjustments

(a) and (d) It is determined depreciation and amortization of emergency facilities is allowable on the basis of original costs to Reef Fields Gasoline Corporation. For a summary of the adjustments see Exhibit "A" attached.

(b) Organization expenses of $88.52 are determined to be nondeductible expenses.

(c) You deducted the sum of $65,610.00 as interest on your Series A and C notes payable to your stockholders. This amount is determined to constitute dividends when paid rather than interest.

As part of the alleged purchase price of your properties, you issued your Series B and D notes in the total face amount of $479,000.00, providing interest at 5 3/4 percent and 6 1/4 percent per annum, respectively, which were pledged to secure George Strong Trustee notes of like series and face amounts, providing interest at 5 1/2 percent and 6 percent, respectively. It is determined the interest differential of one-fourth of one percent on the above-described notes, amounting to $598.75, is nondeductible.

Reef Corporation - 3 - Taxable year Dec. 15, 1958 to June 30, 1959

Computation of Tax

Taxable income as adjusted	$276,039.64
Combined normal tax and surtax: 52% of $276,039.64, less $5,500.00	$138,040.61
Income tax liability	$138,040.61
Income tax assessed on return: Original Account No. CI 707	67,345.43
Deficiency in income tax	$ 70,695.18

REEF CORPORATION

Exhibit "A"

Summary of Adjustments to Depreciation and Amortization
Period December 15, 1958 to June 30, 1959

Description	Amount Claimed	Allowable	Increase (Decrease) In Income
Automotive Equipment	$ 1,348.00	$ 1,348.00	$ -
Plant Equipment			
Straight Line	-	47,625.25	(47,625.25)
150% Declining Balance	247,412.00	114,972.51	132,439.49
200% Declining Balance	7,962.00	7,962.00	-
Equipment transferred to J.R.Butler, et al 3-1-59, $312,323.12 @ 6% for 4 months	-	(6,246.46)	6,246.46
Subtotals	$ 256,722.00	$ 165,661.30	$ 91,060.70
Amortization	-	21,405.69	(21,405.69)
Totals	$ 256,722.00	$ 187,066.99	$ 69,655.01

RECEIVED DEC 24 1962

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
OFFICE OF REGIONAL COMMISSIONER
APPELLATE DIVISION
8031 FEDERAL BUILDING
515 RUSK AVENUE
HOUSTON 2, TEXAS

CERTIFIED

EXHIBIT B

DEC 21 1962

IN REPLY REFER TO
Form L-21A
AP:H:WRT:90-D

TAXABLE YEAR ENDED	DEFICIENCY
6-30-59	$111,894.40

Reef Corporation (Successor in name
to Reef Fields Gasoline Corporation)
2138 Bank of the Southwest Building
Houston 2, Texas

Gentlemen:

In accordance with the provisions of existing internal revenue laws, notice is given that the determination of your income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount(s) shown above. The attached statement shows the computation of the deficiency or deficiencies.

IF YOU AGREE to this determination, please sign the enclosed agreement, Form 870, and return it promptly to this office. An addressed envelope is enclosed for this purpose. The signing and filing of this agreement will permit an early assessment of the deficiency or deficiencies and will limit the accumulation of interest.

IF YOU DO NOT AGREE, and do not sign and return the enclosed form, the deficiency or deficiencies will be assessed for collection, as required by law, upon the expiration of ninety days from the date of this letter, unless within that time you contest this determination in the Tax Court of the United States by filing a petition with that Court in accordance with its rules, a copy of which may be obtained by writing to its Clerk, Box 70, Washington 4, D. C.

Sincerely yours,

MORTIMER M. CAPLIN

Commissioner

By Roy W. Hann
Roy W. Hann
Associate Chief

Enclosures:
Statement
Agreement, Form 870
Addressed envelope

STATEMENT

AP:H:WRT:90-D

Reef Corporation (Successor in name
to Reef Fields Gasoline Corporation)
2138 Bank of the Southwest Building
Houston 2, Texas

Summary of Tax Liability

Year ended	Deficiency
6-30-59	$111,894.40

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated July 14, 1961; to your protest executed September 19, 1961; and to the statements made at the conferences held on July 6, 1962 and September 25, 1962.

It is determined that the series of transactions which occurred commencing in 1958 and ending in April 1959, and involving you and Reef Fields Gasoline Corporation, did not in substance create a new taxpayer but constituted a mere change of name or a reorganization.

The corporate existence of Reef Fields Gasoline Corporation for tax purposes is determined to have continued in the name of Reef Corporation.

As a result the following adjustments are required:

(1) The fiscal year of the "new" corporation arising from the reincorporation has been disregarded.

(2) The increased basis in assets claimed by Reef Corporation based on the alleged purchase from Reef Fields Gasoline Corporation has been disallowed; the basis allowed is the basis of the assets in "Reef Fields Gasoline Corporation".

(3) Expenses incurred relating to the above-described transaction have been determined to be nondeductible.

It is further determined that, if the alleged "sale" could, as you have submitted, be found to have the tax effects of a sale, in any event the Series E and F notes issued by Reef Corporation in the transaction do not represent true indebtedness and in the allocation of costs of depreciable assets 10 percent is allocable to intangibles to be amortized on the basis of an estimated life of 15 years.

A copy of this letter and statement has been mailed to your representative, Mr. Homer L. Bruce, 1617 Esperson Building, Houston 2, Texas.

Taxable year ended June 30, 1959

Adjustments to Taxable Income

Taxable income as disclosed on returns filed			$1,271,985.75
Unallowable deductions:			
(a) Depreciation		$94,060.70	
(b) Reincorporation expense		65,740.85	
(c) Interest expense			
Series A and C notes	$65,610.00		
Series B and C notes	598.75	66,208.75	
Total		$226,010.30	
Additional deduction:			
(d) Amortization, Emergency Facilities		21,405.69	
Net addition			204,604.61
Taxable income as adjusted			$1,476,590.36

Explanation of Adjustments

(a) and (d) It is determined that depreciation and amortization of emergency facilities is allowable on the basis of original cost. For a summary of the adjustments see Exhibit "A" attached.

(b) In connection with the alleged "sale" of your properties, your alleged liquidation and the organization of Reef Corporation you deducted the total sum of $65,740.85, which amount is determined to be nondeductible expenses.

(c) Reef Corporation deducted the sum of $65,610.00 as constituting interest on its Series A and C notes payable to its stockholders. This amount is determined to constitute dividends when paid rather than interest, and the claimed interest deduction is not, therefore, allowable.

As part of the alleged purchase price of your properties, Reef Corporation issued its Series B and D notes in the total face amount of $479,000.00, providing interest at 5 3/4 percent and 6 1/4 percent per annum, respectively, which were pledged to secure George Strong Trustee notes of like series and face amounts, providing interest of 5 1/2 percent and 6 percent per annum, respectively. In view of the determination made that, in substance, there was no purchase by you of your properties from "Reef Fields Gasoline Corporation", the one-fourth percent interest differential on the above-described notes, amounting to $598.75, is restored to taxable income.

Reef Corporation (Successor in name to Reef Fields Gasoline Corporation) - 3 - Taxable year ended June 30, 1959

Computation of Tax

Taxable income as adjusted		$1,476,590.36
Combined normal tax and surtax: 52% of $1,476,590.36		$ 762,326.99
Income tax liability		$ 762,326.99
Income tax assessed on returns:		
Reef Fields Gasoline Corporation; Original Account No. CI 556	$583,087.16	
Reef Corporation; Original Account No. CI 707	67,345.43	650,432.59
Deficiency in income tax		$ 111,894.40

Exhibit "A"

Reef Corporation (Successor in name to Reef Fields Gasoline Corporation)

Summary of Adjustment to Depreciation and Amortization

Description	Claimed on Returns: Reef Fields Gasoline Corp.	Reef Corp.	Total Claimed	Allowable	Increase (Decrease) In Income
Automotive Equipment	$ 2,670.92	$ 1,348.00	$ 4,018.92	$ 4,018.92	$ -
Plant Equipment:					
Straight Line	93,250.41	-	93,250.51	139,875.76	(46,625.25)
150% Declining Balance	229,945.02	247,412.00	477,357.02	344,917.53	132,439.49
200% Declining Balance	-	5,962.00	5,962.00	5,962.00	-
Equipment transferred to J.R.Butler et al 3-1-59 ($312,323.12 @ 6% for 4 months	-	-	-	(6,246.46)	6,246.46
20% 1st year depreciation	2,000.00	2,000.00	4,000.00	2,000.00	2,000.00
Subtotals	$327,866.45	$256,722.00	$584,588.45	$490,527.75	$94,060.70
Amortization	42,811.37	-	42,811.37	64,217.06	(21,405.69)
Totals	$370,677.82	$256,722.00	$627,399.82	$554,744.81	$72,655.01

INDEX

Page

Appendix 15

CITATIONS

Cases:

Arlington Park Jockey Club v. *Sauber*, 262 F. 2d 902 8

Babcock v. *Phillips*, decided January 27, 1967 (C.A. 10), petition for certiorari pending, No. 1215, this Term 6, 7

Bard-Parker Co. v. *Commissioner*, 218 F. 2d 52, certiorari denied, 349 U.S. 906 6

Bazley v. *Commissioner*, 331 U.S. 737 12

Cabot Corp. v. *United States*, 220 F. Supp. 261, affirmed per curiam, 326 F. 2d 753 13

Columbia Gas of Maryland, Inc. v. *United States*, 366 F. 2d 991 13

Commissioner v. *Morgan*, 288 F. 2d 676, certiorari denied, 368 U.S. 836 ..... 6, 7

Comstock v. *Group of Investors*, 335 U.S. 211 9

Corn Products Co. v. *Commissioner*, 350 U.S. 46 9

Cortland Specialty Co. v. *Commissioner*, 60 F. 2d 937, certiorari denied, 288 U.S. 599 8

Davant v. *Commissioner*, 366 F. 2d 874, pending on petition for writ of certiorari, No. 911, this Term 6, 7, 13

Gilbert v. *Commissioner*, 262 F. 2d 512, certiorari denied, 359 U.S. 1002 8

Gooding Amusement Co. v. *Commissioner*, 236 F. 2d 159, certiorari denied, 352 U.S. 1031 8

258-373—67——1

Cases—Continued

	Page
Heller v. *Commissioner*, 2 T.C. 371, affirmed, 147 F. 2d 376, certiorari denied, 325 U.S. 868	7
Helvering v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179	5
Helvering v. *Southwest Consolidated Corp.*, 315 U.S. 194	12, 13
Helvering v. *Watts*, 296 U.S. 387	8
Kelley, John, Co. v. *Commissioner*, 326 U.S. 521	8
Kruse, O. H., Grain & Milling v. *Commissioner*, 279 F. 2d 123	8
LeTulle v. *Scofield*, 308 U.S. 415	8, 9
Lewis v. *Commissioner*, 176 F. 2d 646	6
Liddon v. *Commissioner*, 230 F. 2d 304, certiorari denied, 352 U.S. 824	6, 7
Love v. *Commissioner*, 113 F. 2d 236	6
Minnesota Tea Co. v. *Helvering*, 302 U.S. 609	5, 12
Moffatt v. *Commissioner*, 363 F. 2d 262, pending on petition for writ of certiorari, No. 804, this Term	6, 7
Montclair, Inc. v. *Commissioner*, 318 F. 2d 38	8
Pinellas Ice Co. v. *Commissioner*, 287 U.S. 462	8, 9

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 163(a)	15
Sec. 354(a)	15
Sec. 354(b)	15
Sec. 362(b)	15
Sec. 368	16
Sec. 381	17
Sec. 4382(b)	13

Miscellaneous:

H. Rep. No. 1337, 83d Cong., 2d Sess., p. 41	12

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1005

REEF CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The principal issue presented by this tax case is whether the transfer of assets from one corporation (Old Reef) to a newly formed corporation (New Reef), all the stock of which is owned by the majority stockholders of the old corporation, constitutes a reorganization within the meaning of 1954 Code § 368.

All the stock of Old Reef (a Texas corporation) was owned by two groups of stockholders: the Butler group which operated the company owned approximately 52 percent; the Favrot group which was comprised mainly of investors owned 48 percent. In 1958, the Butler group decided to have the corporation buy out the Favrot group for $2,920,800 in cash and notes, and a complicated plan was formulated

involving an intermediary (the Strong trust), a new corporate charter, and two sets of notes in identical face amounts. The details of the plan are set out in the opinions of the Tax Court (R. 239–254) and the court below (Pet. 33–34). In brief, the Butler group organized New Reef (a Delaware corporation) and became the owners of all its stock. Then both the Butler and Favrot groups sold their stock in Old Reef to the Strong trust, the Favrot group receiving $2,920,800 in cash and notes and the Butler group $2,624,400 in notes (the Butler group already having received all of the stock of New Reef). Simultaneously, Old Reef sold its operating assets to New Reef for notes in identical face amounts to those issued by the Strong trust. Old Reef was then liquidated and the Strong trust (its sole shareholder) received cash and notes equal to the cash and notes it had paid for Old Reef's stock. The trust immediately pledged the notes received from New Reef to secure the notes issued to the Butler and Favrot groups and, in accordance with the terms of its original notes, the trust was thereby relieved of all personal liability for payment of either interest or principal. (R. 243–254; Pet. 33–34.)[1]

The net result of this complex series of steps was as follows: The business which had been operated by Old Reef continued without interruption under a new corporate charter (New Reef) with the same management, employees and customers. The Butler

[1] "R." references are the printed record in the court of appeals.

group's ownership in the corporate enterprise was increased from 52 percent to 100 percent, while the Favrot group's 48 percent ownership was completely redeemed.

New Reef now claims that because of this change (1) its basis for depreciation in the assets received from Old Reef has been stepped-up so that the assets' basis is now $3,828,860 higher than it had been in the hands of Old Reef; (2) it is entitled to deduct, as "interest," payments on the notes issued to the Butler group (New Reef's sole shareholders) and held by them in exactly the same proportions as their stock ownership; and (3) Old Reef's taxable year terminated at the time of the transaction. (R. 253, 256–257.)

The Tax Court held that the transaction constituted a "D" (although not an "F") reorganization, so that Old Reef's basis in its assets carried over to New Reef. It also found that the notes of New Reef which were held by the Butler group of shareholders in proportion to their stockholdings actually represented equity capital rather than indebtedness, so that New Reef was not entitled to "interest" deductions for payments on those notes.[2] (R. 281–287.) The court of appeals sustained the Tax Court's holding that a "D" reorganization had occurred (Pet. 37–42) and that New Reef was not entitled to the claimed interest deductions (Pet. 32–44). It also held that the transfer

[2] No issue was raised with respect to the interest paid on the notes issued to the Favrot group, which owned no stock in New Reef.

of assets constituted an "F" reorganization, so that Old Reef's taxable year did not end at the time of the transaction. On this point, the court noted that distilling the "intricate and confusing facts of this case * * * to their pure substance, two distinct and unrelated events transpired. First, [the Favrot group which owned] 48% of the stock in [Old Reef] had their stockholdings completely redeemed. Second, New Reef was formed and the assets of [Old Reef] were transferred to New Reef" in an "F" reorganization (Pet. 46).

The decision below is correct. There is no conflict of decisions or other reason for further review by this Court.

1. *The "D" reorganization issue.*—In general, if substantially all the assets of a corporation (here Old Reef) are transferred to a new corporation (here New Reef) which is controlled by the transferor corporation or one or more of its stockholders, the transaction constitutes a "D" reorganization. 1954 Code §§ 368(a)(1)(D), 354(b). In such a case, the assets transferred have the same basis for depreciation in the hands of the new corporation (New Reef) as they did to the old corporation (Old Reef). 1954 Code § 362(b). Petitioner argues, however, that, even though Old Reef's business continued uninterrupted in the new corporate shell (New Reef), the instant transaction nevertheless does not constitute a "D" reorganization and that it should be allowed to increase the assets' basis for depreciation by more than $3,800,000.

(a) Petitioner first contends (Pet. 11–15) that the shareholders of Old Reef immediately before the transaction did not control New Reef immediately after the transaction. They argue that the Butler and Favrot groups had sold their stock in Old Reef to the Strong trust before the transfer of assets took place and that the trust independently decided to have Old Reef sell its assets to New Reef. As both lower courts held, the Strong trust acted merely as a conduit (Pet. 31–37, 41; R. 272). Pursuant to a prearranged plan the trust (1) purchased all the stock of Old Reef from the Butler and Favrot groups, (2) had Old Reef sell its operating assets to New Reef (which was wholly owned by the Butler Group), and (3) liquidated Old Reef, receiving cash and notes precisely equal to the price it had paid for Old Reef's stock. At most the trust held title to the Old Reef stock for only a short period while the preconceived plan was carried out. Therefore, the lower courts correctly held that immediately before the transaction began Old Reef's stock was owned by the Butler (52%) and Favrot (48%) groups, so that one or more of Old Reef's shareholders (the Butler group) not only controlled New Reef, but owned 100 percent of its stock. See, *e.g.*, *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184–185; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613–614.

(b) Petitioner next contends (Pet. 15–22) that the transfer of assets from Old Reef to New Reef constituted a sale rather than a reorganization because Old Reef received notes rather than New Reef stock in ex-

change for its assets. The courts, however, have long rejected such formalistic arguments and held that whenever one corporation transfers its essential business enterprise to another corporation *which is controlled by one or more of the transferor corporation's stockholders*, the transaction constitutes a "D" reorganization, regardless of the form in which the transaction is cast. See, *e.g.*, *Lewis* v. *Commissioner*, 176 F. 2d 646 (C.A. 1); *Love* v. *Commissioner*, 113 F. 2d 236 (C.A. 3); *Bard-Parker Co.* v. *Commissioner*, 218 F. 2d 52 (C.A. 2), certiorari denied, 349 U.S. 906; *Liddon* v. *Commissioner*, 230 F. 2d 304 (C.A. 6), certiorari denied, 352 U.S. 824; *Commissioner* v. *Morgan*, 288 F. 2d 676 (C.A. 3), certiorari denied, 368 U.S. 836; *Moffatt* v. *Commissioner*, 363 F. 2d 262 (C.A. 9), petition for writ of certiorari pending, No. 804, this Term; *Davant* v. *Commissioner*, 366 F. 2d 874 (C.A. 5), petition for certiorari pending, No. 911, this Term; *Babcock* v. *Phillips* (C.A. 10), decided January 27, 1967, petition for writ of certiorari pending, No. 1215, this Term.

Petitioner argues that no "D" reorganization could have taken place unless New Reef transferred some of its stock to Old Reef in consideration for the latter's assets. Both lower courts held that the $2,624,400 in New Reef's subordinated notes issued to the Butler group in exact proportion to their stockholdings in New Reef constituted "risk capital" and actually represented an equity investment (Pet. 42–44; R. 282–287). Thus, a substantial part of the consideration which New Reef paid for Old Reef's assets

consisted of New Reef's "stock." And, as required by § 354(b)(1), Old Reef distributed all of the stock and securities which it received from New Reef. Thus, even under petitioners argument—that the transferee (New Reef) must give the transferor (Old Reef) some of the former's stock in part payment for the latter's assets—the instant transaction qualifies as a "D" reorganization. Moreover, as discussed at greater length in our Brief in Opposition to Certiorari in *Davant* v. *Commissioner*, No. 911, this Term (pp. 5–7), all of the lower courts which have passed on the question have concluded that, in cases like the instant one, the new corporation need not transfer any stock to the old corporation in part payment for its assets, if one or more of the old corporation's stockholders already own all the stock of the new corporation.[3]

[3] Since the Butler group, which owned the majority of Old Reef's stock, already owned 100 percent of New Reef's stock, it made no difference to them whether New Reef paid for Old Reef's assets in part by issuing some of its own stock; this would merely have increased the number of shares of Old Reef's common stock which they owned, but would not have effected any substantive change in their ownership. "To require the actual transfer of stock certificates where such a transfer would be a meaningless gesture would be to make the reorganization provisions optional with the taxpayer, a result which Congress clearly did not intend." *Davant* v. *Commissioner*, *supra*, p. 887. Accord: *Liddon* v. *Commissioner*, *supra*; *Commissioner* v. *Morgan*, *supra*; *Heller* v. *Commissioner*, 2 T.C. 371, affirmed, 147 F. 2d 376 (C.A. 9), certiorari denied, 325 U.S. 868; *Moffatt* v. *Commissioner*, *supra*; *Babcock* v. *Phillips*, *supra*.

Moreover, contrary to petitioner's contentions (Pet. 19), neither the result reached by the court of appeals nor its

2. *Deductibility of the "Interest" payments.*—The lower courts also correctly concluded that the so-called interest paid on the New Reef notes which were issued to the Butler group was not deductible as "interest * * * on indebtedness." Both lower courts concluded that these notes did not represent true "indebtedness" but were part of the risk capital invested by the Butler group in New Reef (Pet. 42–44; R. 282–287). This holding is essentially one of fact, depending on all the relevant circumstances.[4] Without seeking to discuss fully all of the factors taken into account by the courts below we note that all the notes were held by the stockholders of New Reef in proportion to their stock investment; all were subordi-

reasoning is in conflict with cases like *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462; *LeTulle* v. *Scofield*, 308 U.S. 415, and *Cortland Specialty Co.* v. *Commissioner*, 60 F. 2d 937 (C.A. 2), certiorari denied, 288 U.S. 599. In those cases a corporation transferred its assets to another corporation in exchange for cash and short term notes, and the stockholders of the transferor corporation did not own any stock in the transferee. Thus the courts held that such a transaction did not constitute a reorganization because the "continuity of interest" requirement was not met, *i.e.*, the stockholders of the transferor corporation had no continuing equity interest in the transferee. See also *Helvering* v. *Watts*, 296 U.S. 387. In the instant case, however, the "continuity of interest" requirement was clearly satisfied, since one or more of Old Reef's stockholders owned all the stock of New Reef.

[4] See, *e.g.*, *John Kelley Co.* v. *Commissioner*, 326 U.S. 521; *Gilbert* v. *Commissioner*, 262 F. 2d 512 (C.A. 2), certiorari denied, 359 U.S. 1002; *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C.A. 6), certiorari denied, 352 U.S. 1031; *Montclair, Inc.* v. *Commissioner*, 318 F. 2d 38 (C.A. 5); *Arlington Park Jockey Club* v. *Sauber*, 262 F. 2d 902 (C.A. 7); *O. H. Kruse Grain & Milling* v. *Commissioner*, 279 F. 2d 123 (C.A. 9).

nated to the claims of the life insurance loan used to redeem the stock of the Favort group; they were issued for assets essential to the business; and by their terms payment of both principal and interest was dependent on future earnings, the court of appeals estimating that the serial payments on the notes would not even begin until approximately seven years after the transaction. Thus, contrary to petitioner's contentions (Pet. 22–25), the concurrent findings of the courts below are amply supported by the record, and are entitled to finality here. See *Corn Products Co.* v. *Commissioner,* 350 U.S. 46; *Comstock* v. *Group of Investors,* 335 U.S. 211, 214.[5]

3. *The "F" reorganization issue.*—The third principal issue in this case is whether the transaction constitutes an "F" reorganization—*i.e.,* "a mere change in identity, form, or place of organization, however effected." 1954 Code § 368(a)(1)(F). Even though, as discussed *supra,* pp. 4–7, the transaction constitutes a "D" reorganization, it is nevertheless necessary to decide whether it also qualifies as an "F" reorganization. Although most of the important tax questions (such as carry-over basis for the assets) are settled by a determination that the transaction is a "D" reorganization, the question of whether the new and

[5] Petitioner argues that this holding conflicts with cases like *Pinellas Ice* and *LeTulle* (Pet. 23). As discussed, *supra,* fn. 3, pp. 7–8, those cases involve far different fact situations. In those cases the recipients of the new corporation's notes did not own any stock in that corporation and thus there was no claim, as there is here, that notes of the new corporation held pro rata by the shareholders of the new corporation really represent disguised equity capital.

old corporations are sufficiently distinct so that the old company should file a tax return for the partial taxable year ending with the reorganization and the new corporation file a separate tax return beginning with the date of the reorganization turns on whether the transaction qualifies as an "F" as well as a "D". Code § 381, which was enacted for the first time in 1954, makes it clear that when an "F" reorganization takes place, the old corporation does not file a separate income tax return for a portion of a year ending on the date of the reorganization but that the new corporation is regarded as a continuation of the old. However, if the reorganization does not qualify as an "F", the old corporation's taxable year ends on the date of the reorganization and the new corporation files a separate return beginning on that date. 1954 Code § 381(b).

The instant transaction took place during Old Reef's fiscal year beginning July 1, 1958. The court of appeals held that the transaction constituted an "F" reorganization as well as a "D" so that the two corporations should have filed a single return for the period July 1, 1958, to June 30, 1959. That court correctly looked through the form of the instant transaction and observed (Pet. 46, 52–53):

> Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48% of the stock in [Old] Reef [redacted] had their stockholdings completely redeemed. Second, new Reef was formed and the assets of [Old] Reef were transferred to new Reef. The business enterprise continued with-

> out interruption during both the redemption and the change in corporate vehicles.
>
> Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a standard, these two elements were functionally unrelated. [Old] Reef could have completely redeemed the stock of 48% of its shareholders without changing the state of its incorporation. * * *
>
> * * * * * *
>
> If a corporation did no more than completely redeem the stock interest belonging to 48% of its shareholders, it could not under the Code make wholesale accounting method changes. Likewise, if a corporation did no more than change its name and state of incorporation, it could not under the Code make wholesale accounting method changes. Combining these two events, neither of which would be sufficient alone, will not permit a corporation to make wholesale accounting method changes. Nothing in the Internal Revenue Code of 1954 contemplates such a result.

This holding is in accord with the statutory scheme and the underlying purpose of the Code, and is consistent with the decisions of this and other courts. Since neither a redemption nor a change in the state of incorporation standing alone would permit a corporation to change its taxable year or accounting methods, a corporation should not be able to produce a different tax result by merely combining the two. Although the redemption and the reincorporation were executed at the same time, they were not func-

tionally related. Cf. *Bazley* v. *Commissioner*, 331 U.S. 737, 742; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613.

Petitioner asserts conflict with *Helvering* v. *Southwest Consolidated Corp.*, 315 U.S. 194, wherein this Court held (pp. 202–203) that an "F" reorganization had not occurred because of the substantial change in the proprietary interest in the transferor and transferee corporations. But, viewing this case as involving two functionally unrelated events—a redemption by Old Reef of the Favrot group's 48 percent interest and then a change in the state of incorporation—as did the court of appeals, the Butler group owned all of Old Reef's stock before the reincorporation and all of New Reef's stock after. In *Southwest Consolidated*, on the other hand, there was a complete change in stock ownership between the new and the old corporations, *i.e.*, the shareholders of the old corporation owned none of the stock of the new corporation. Finally, even if *Southwest Consolidated* were not completely distinguishable from the instant case, the significant changes made in the Internal Revenue Code of 1954—such as the enactment of § 381, which was designed to prevent a corporation from "escap[ing] the tax consequences of the law [relating to carryover of accounting methods] by means of a legal artifice," such as combining a redemption with a change in the state of incorporation (H. Rep. No. 1337, 83d

Cong., 2d Sess., p. 41—might render the *Southwest* decision inapposite.[6]

The petition for a writ of certiorari should be denied.[7]

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[6] Nor does the instant decision conflict, as petitioner argues (Pet. 26–27), with *Columbia Gas of Maryland, Inc.* v. *United States*, 366 F. 2d 991 (Ct. Cl.) and *Cabot Corp.* v. *United States*, 220 F. Supp. 261 (D. Mass.), affirmed *per curiam*, 326 F. 2d 753 (C.A. 1). Both of those cases dealt with the excise tax which is imposed on the issuance and transfer of stock and securities and the exception for a transaction which is "a mere change in identity, form, or place of organization." Code § 4382(b)(1)(D). The Court of Claims explicitly recognized that because of the legislative history and administrative practice, this excise tax exception may well be narrower than the income tax "F" reorganization provision which is here in question. *Columbia Gas*, *supra*, p. 995. Moreover, both of those cases involved transactions which are far different than the instant case. *Columbia Gas* involved a divisive reorganization in which one corporation was split up into two separate businesses. *Cabot* involved a consolidation of four separate corporations into one. Thus neither case is apposite here, where a single corporation's business was transferred to a single new corporation organized in a different state. See also fn. 6, p. 11, of our Brief in Opposition in *Davant* v. *Commissioner*, No. 911, this Term.

[7] As a protective device, the Commissioner issued two deficiency notices which were intended to be in the alternative: one, based on the theory that the transaction constituted an "F" reorganization, covered a full taxable year; the other, based on the theory that the transaction constituted only a "D" reorganization, covered a short taxable year. Since the Tax Court held the transaction to be a "D" reorganization but not an "F", it upheld the deficiency notice for the short period. The court of appeal's conclusion that the transaction was an "F" validates the full-year deficiency notice. Thus the court of appeals should have remanded the portion of the case dealing with the short-period deficiency notice so the Tax Court could dismiss that part of the case. Instead it affirmed as to the short period

Respectfully submitted.

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APRIL 1967.

(petitioner's appeal) and remanded only as to the full year deficiency notice (the government's appeal) (Pet. 56). Thus, as petitioner points out (Pet. 28–29), there are presently two overlapping deficiency notices outstanding against it. However, there is no substance to petitioner's suggestion that the decision below may subject it to two assessments. The Commissioner will, upon disposition of this petition, join with petitioner in asking the court of appeals to order a remand of the entire case, which will permit the Tax Court to reassume jurisdiction with respect to the deficiency notice covering the short period and dismiss it from the case.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * * *

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) *General Rule.*—

(1) *In general.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * * *

(b) *Exception.*—

(1) *In general.*—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

* * * * * *

SEC. 362. BASIS TO CORPORATIONS.

* * * * * *

(b) *Transfers to Corporations.*—If property was acquired by a corporation in connection

with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

* * * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*—

(1) *In general.*—For purposes of parts I and II and this part, the term "reorganization" means—

* * * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

* * * * *

(F) a mere change in identity, form, or place of organization, however effected.

* * * * *

(c) *Control.*—For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock en-

titled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) *General Rule.*—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

(b) *Operating Rules.*—Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary or his delegate, the date when substantially all of the property has been distributed or transferred may be used if the

distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1967

SUPREME COURT, U. S.

APR 20 1967

JOHN F. DAVIS, CLERK

NO. 1005

IN THE

Supreme Court of the United States

October Term, 1966

REEF CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Fifth Circuit

REPLY BRIEF OF PETITIONER

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INDEX

CITATIONS

Cases:	Page
Babcock v. Phillips, petition No. 1215 on this Court's present docket.	13
C.I.R. v. Brown, 380 U.S. 563	8
C.I.R. v. Morgan, 288 F.2d 676	13, 14
J. E. Davant et al. v. C.I.R., petition No. 911 on this Court's present docket.	8, 13
Hanover Bank v. C.I.R., 369 U.S. 672	14
Helvering v. Flaccus Leather Co., 313 U.S. 247	14
Helvering v. Hammel, 311 U.S. 504	14
Moffatt v. C.I.R., 363 F.2d 262	13
Old Colony Railroad Co. v. C.I.R., 284 U.S. 552	14
Turnbow v. C.I.R., 368 U.S. 337	14
Statutes:	
Internal Revenue Code of 1954:	
Sec. 354	8
Sec. 368	3, 8, 11
Sec. 6212	10, 11
Miscellaneous:	
S. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 42	2

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---

REPLY BRIEF OF PETITIONER

Just as we state in our reply to the memorandum of the respondent in J. E. Davant, et al. v. Commissioner of Internal Revenue, No. 911, on the present docket of this Court, we submit that a real consideration of the argument of respondent will clearly demonstrate how erroneous are the decisions of the courts below.

In the *Davant* case the respondent refers to only a part of the statement by the Senate Finance Committee in

reference to the reorganization provisions of the 1954 Internal Revenue Code S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 42. In that case we set out the entire part of that report insofar as it deals with these two cases. We quote the following part:

> "The House bill, in the opinion of your committee, contains several important provisions which, by spelling out detailed rules in an attempt to achieve almost mathematical certainty, *would make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws.*
>
> "The House bill in this area is, in substance, an entirely new statute using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, *it has sought to rewrite it so as to preserve the terms and concepts of existing law wherever possible.* It has, however, not hesitated to depart from the present statute *where such departure was necessary in order to remove unwarranted restrictions on necessary or desirable business transactions* or to preclude the use of avoidable devices which have proved successful under the existing code." (Emphasis added)

On the other hand let us see the extremes to which the courts below and respondent have gone to have the tax laws act with a *maximum degree* of interference with a simple ordinary business transaction.

It is true that the present case involves only Reef Corporation and the question of whether its basis for depreciation of the assets bought from Reef Fields is their cost to it or the old lower basis of Reef Fields. The respondent treats the whole transaction as an effort by Reef to get this higher basis by avoiding a reorganization

under sec. 368(a)(1)(D). Actually the effect on Reef was never even considered and this basis point arose entirely separate from the main transaction. We can show this very quickly.

As shown in our petition three men, Butler, Miller and Lents, were oil and gas engineers and put Reef Fields together to build this casinghead gasoline extraction plant. They operated the plant with Lents primarily in charge. Reef Fields had outstanding 40,800 shares. Butler, Miller and Lents and their associates in the Butler group formed Reef with 38,200 shares. Petitioner's Exhibit 47 shows how these three owned the stock in each corporation, the following being copied from Exhibit 47:

	Reef Fields Gasoline Corporation		Reef Corporation	
	Stock Owned	%	Stock Owned	%
J. R. Butler	3,092	7.58	8,040	20.98
M. R. Lents	1,696	4.16	6,740	17.59
Martin G. Miller	996	2.44	6,008	15.68
	5,784	14.18	20,788	54.25

After that Exhibit 47 had been put in evidence, Lents on direct examination by the undersigned Homer L. Bruce explained the whole transaction.

"By Mr. Bruce:

A. The latter part of 1958, Mr. Lents, how did you feel about owning 4.16 per cent interest in the Reef Field Gasoline Corporation and being its manager and devoting substantially all of your time to it?

A. Obviously, I wanted to increase my ownership in the operation that I had put together out there, and I went to my two partners and proposed to them that we try to buy out all the other stockholders that we could.

Q. Now, did you take the matter up with men, like, say, Favrot and Peterkin and some of the other leading ones to determine whether they wanted to sell or what they wanted to do?

A. Yes, sir, we took it up with all the stockholders. Actually, Mr. Butler had the initial discussion with him.

Q. State whether or not it was decided that you would form a new corporation, Reef Corporation.

A. *Yes, we, of course, assumed that we had to form a new company.* I chose the name of Reef Corporation mainly because I wanted a name that smacked of the old name because it would help me to some extent, to have a little continuity where casinghead contracts were concerned.

Q. What was the final price per share that was agreed upon as to the stockholders who were going to sell their stock? I am not trying to break it down into notes or anything but, say, the total aggregate per share.

A. $150 per share." (R. 49-50)

"Q. Now, was the matter ever considered one way or the other as to whether Reef was going to pay $150 per share in cash or what was it going to do? I believe, Mr. Lents, the record already shows or the record will show how many shares were sold, and at $150 per share, this would come up to something over five million dollars.

Could Reef pay that amount in cash?

A. No, sir. We couldn't come up with that much money.

Q. Then state whether or not it was known to all parties that Reef would have to give practically all

of the consideration in the form of notes of some kind.

A. Well, I wouldn't say practically all. Final negotiations wound up with $62.50 a share cash and the balance a note.

Q. In other words, Reef itself did not have the cash to pay this whole five million dollars?

A. That's right.

Q. Now, was it considered how you would handle this transaction, or was there a plan whereby Reef Fields Gasoline Corporation would sell their assets to Reef Corporation for all these notes?

A. That it—

Q. You are familiar with A, B, C, D, E, and F notes Reef gave for all the assets, are you not?

A. Yes, sir.

Q. *Was it considered whether Reef Fields should sell these assets to Reef for these notes and then dissolve the corporation in 1958 and distribute these notes to the stockholders and whatever cash it had?*

A. That is the way we thought of first.

Q. Was that satisfactory to all of you?

A. It was until you told us we would all have to pay a capital gains tax on these notes which we were going to get, we couldn't make the deal that way." (R. 51-52)

"Q. State whether or not you were advised—

A. I was advised.

Q. Wait a minute. State whether or not you were advised that if Reef Fields sold its properties to Reef Corporation for these A to F notes, then Reef Fields dissolved their corporation in 1958 and distributed these notes to the stockholders and whatever cash it had, the stockholders in Reef Fields would thereupon incur a capital gains tax on the whole amount in 1958 on their property?

A. Yes.

Q. State whether or not that was satisfactory to you and the other partners.

A. It was not.

Q. State whether or not you are familiar with the method of making sales of property under the Internal Revenue Code and returning your profit on an installment basis.

A. Yes, sir, I am familiar with that and was at that time, yes.

Q. Now, state whether or not stockholders in coming to the final decision as to the plan and whether you wanted to arrange it so that you would come under the installment reporting basis.

A. Yes, that is the way we wanted to do it so when we received the money we would pay the tax.

Q. Now, state whether or not that matter was discussed with Mr. Favrot and the crowd that sold out in December, 1956.

The Court:
You mean 1958, Mr. Bruce?

Mr. Bruce:
Yes, 1958.

A. Yes, sir. It was discussed with them.

Q. I believe the record shows that Mr. Favrot and some of them all sold out in 1958, is that correct?

A. Yes, sir, some of them did make their sale at that time." (R. 53-54)

"Q. Mr. Lents, state whether or not some of the stockholders sold their stock in December, 1958 to Mr. George Strong, Trustee.

A. Yes, sir, several of them.

Mr. Friedman:
Again, we object to the word 'sold' in reference to these transactions. This is a legal conclusion.

The Court:
He is using the word as used in common parlance, that they handed it over and got some money.

Mr. Bruce:

I would like to have that understanding, that we are using the word 'sold', not in the technical manner, but in the usual sense.

The Court:

We very often have a question where there is no question somebody handed something over and got money for it and the whole issue—

Mr. Friedman:

With that understanding and agreement with Mr. Bruce, I will make no further objection of this type." (R. 55-56)

"Q. Mr. Lents, I will not go through the details of how this transaction was handled through George Strong, Trustee. I want to take that up with another witness who is more familiar with the details. But state whether or not at that time you understood how the various parties and some in December and some in January, were selling their stock to George Strong, Trustee, and then Reef Fields was going to be dissolved. Were you familiar with that?

A. Yes, sir.

Q. Were you familiar with the general set-up?

A. Yes, sir.

Q. *State whether or not you decided to go through that transaction rather than having simply Reef Fields sell the properties for these notes and dissolve and distribute these notes to you.*

A. Yes, sir." (R. 56-57)

We will not restate our views as to why the sale to George Strong, Trustee, should be sustained. We refer to our discussion of that point in our petition for writ of certiorari. However, we refer briefly to respondent's statement on page 5 of his memorandum:

"At most the Trust held title to the Old Reef stock for only a short period while the preconceived plan was carried out."

In *Commissioner v. Brown*, 380 U.S. 563, this Court sustained the transaction where there was a sale to an exempt foundation and it immediately transferred the properties to a corporation

> "while the preconceived plan was carried out."

How can those presently representing the respondent make the statement on page 4 of their memorandum,

> "In general, if substantially all the assets of a corporation (here Old Reef) are transferred to a new corporation (here New Reef) which is controlled by the transferor corporation or one or more of its stockholders, the transaction constitutes a "D" reorganization. 1954 Code §§368(a)(1)(D), 354(b)."

That statement certainly is a condensed statement of all the intricate requirements set out by Congress in sections 368(a)(1)(D) and 354(b) before there can be a (D) reorganization, and it is clear to us that the facts in this case show that there was no (D) reorganization. We have discussed in detail in our reply brief in *J. E. Davant, et al. v. Commissioner*, No. 911 on the docket of this Court how some of the courts have tried to get around the express provisions of (D) by saying that it would be a meaningless gesture for additional stock to be issued in the *Davant* case and in this case and we refer the court to our discussion in the *Davant* case.

As to the holding of the court below that there was a 368(a)(1)(F) reorganization, how could under the facts of this case it be held that the new corporation Reef was

> "a mere change of identity, form, or place of organization, however effected"?

Right in that connection and with the statement on page 8 of respondent's memorandum in reference to the notes that

> "we note that all the notes were held by the stockholders of New Reef in proportion to their stock investments;"

this statement has absolutely no support in the record. We will not give the figures concerning all the stockholders of Reef but will give the figures concerning Butler, Miller and Lents and one of the larger stockholders, Saunders. Of the total of 38,320 shares of Reef and its notes of $4,903,000 these four men owned the following shares and notes:

	Shares	Per Cent of Shares	Notes	Per Cent of Notes
Butler	8,040	20.98	$ 343,200	7.00
Miller	6,008	15.68	59,280	1.21
Lents	6,740	17.59	153,300	3.13
Saunders	6,768	17.66	720,330	14.69
	27,556	71.91	$1,276,110	26.03

How can the respondent still contend that the notes issued by Reef in the purchase of the assets of Reef Fields that are held by the Butler group are to be treated as stock? He does this both to say there was stock distributed by Reef and to deny Reef the deduction for the interest paid on those notes. Incidentally the Government allowed Reef to deduct the interest on the notes that were held by the Favrot group. How can notes of exactly the same series be stock in the hands of the Butler group and notes in the hands of the Favrot group?

Respondent still says they are notes because they come behind a first mortgage held by the insurance company

and because the lower courts estimated they would not begin to be paid off until after seven years or along in 1965. As shown on pages 24 to 25 of our petition, $2,378,000 of the notes had already been paid off on the trial of the case in April, 1964.

Lastly, we wish to point out the extreme quandary in which the respondent's counsel and the Commissioner find themselves as to whether this was a reorganization under (F) or (D). Reef Fields made its tax returns on a fiscal year basis ending June 30 of each year. It sold its properties to Reef on February 28, 1959 and was formally dissolved on April 27, 1959. On the other hand Reef was incorporated on December 15, 1958 and adopted the June 30 fiscal year. Reef Fields, therefore, filed its last return for the period from July 1, 1958, to April 27, 1959, while Reef filed its first return for the period from December 15, 1958 to June 30, 1959. On the same day, December 21, 1962, the Commissioner of Internal Revenue addressed a deficiency letter to Reef covering the period from December 15, 1958, to June 30, 1959, and a deficiency letter designated "Reef Corporation (Successor in name to Reef Fields Gasoline Corporation)" covering the taxable year from July 1, 1958 to June 30, 1959. Copies of those letters are set forth on pages 89 to 98 of our petition. Reef Corporation filed two petitions with the Tax Court. The one on its docket No. 788-63 involved the one addressed to it for the period from December 15, 1958 to June 30, 1959 (R. 152-166). The one on its docket No. 789-63 involved the one covering the fiscal year from July 1, 1958 to June 30, 1959 (R. 170-188). Section 6212 of the Code provides for such deficiency letters but section 6212(c) provides that, after such a notice of deficiency is mailed, the Commis-

sioner has no right to determine any additional tax for the same year if the taxpayer files a petition within the proper time with the Tax Court. These two sections are as follows:

> "SEC. 6212. NOTICE OF DEFICIENCY
>
> (a) In General—If the Secretary or his delegate determines that there is a deficiency in respect of any tax imposed by subtitles A or B, he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail."
>
> "(c) FURTHER DEFICIENCY LETTERS RESTRICTED.—
>
> (1) General Rule—If the Secretary or his delegate has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the Secretary or his delegate shall have no right to determine any additional deficiency of income tax for the same taxable year, of gift tax for the same calendar year, or of estate tax in respect of the taxable estate of the same decedent, except in the case of fraud, and except as provided in section 6214(a) (relating to assertion of greater deficiencies before the Tax Court), in section 6213(b)(1) (relating to mathematical errors), or in section 6861(c) (relating to the making of jeopardy assessments)."

Petitioner pleaded in each case the issuance of the two letters (R. 154 and 173) and that, since it was impossible to tell which was mailed first, both were invalid. The respondent admitted that they were mailed simultaneously (R. 23). The Tax Court held that there was no reorganization under section 368(a)(1)(F) and, therefore, the deficiency letter to the Reef Corporation as successor was

invalid and dismissed case No. 789-63, but held there was a reorganization under (D) and the other notice was valid. The Court of Appeals held there was a reorganization under both (D) and (F) and both notices were valid.

The respondent in footnote 6 on page 13 of his memorandum takes a very peculiar position. He states that the judgment of the Court of Appeals that there was an (F) reorganization validates the deficiency notice in 789-63 covering the full year from July 1, 1958 to June 30, 1959. He then states:

> "Thus the court of appeals should have remanded the portion of the case dealing with the short-period deficiency notice so the Tax Court could dismiss that part of the case. Instead it affirmed as to the short period (petitioner's appeal) and remanded only as to the full year deficiency notice (the Government's appeal) (Pet. 56). Thus, as petitioner points out (Pet. 28-29), there are presently two overlapping deficiency notices outstanding against it. However, there is no substance to petitioner's suggestion that the decision below may subject it to two assessments. The Commissioner will, upon disposition of this petition, join with petitioner in asking the court of appeals to order a remand of the entire case, which will permit the Tax Court to reassume jurisdiction with respect to the deficiency notice covering the short period and dismiss it from the case."

This is a remarkable statement. How does the respondent know that the petitioner will join with the respondent in asking the Court of Appeals to do what he says we will do? To our minds, this is just one more illustration of the confusion that the Commissioner is bringing into the administration of the tax laws and getting away from all

concepts with which the courts and the bar had become familiar when the Senate wrote its version of the 1954 Code.

CONCLUSION

As we point out on pages 19 to 21 of our petition, this whole line of cases, holding that the specific requirements of sec. 368(a)(1)(D) need not be met if the stock of both corporations is owned by the same parties, started with the two-to-one decision by the Third Circuit Court of Appeals in *Commissioner v. Morgan,* 288 F.2d 676, under the 1939 Code, with Judge Hastie strongly dissenting. Later cases have merely followed it blindly. The taxpayers and the members of the bar do not agree with that line of argument. This is shown by cases questioning it in presently pending petitions for certiorari in this Court, *Moffatt v. Commissioner,* 363 F.2d 262, petition No. 804, this Term; *J. E. Davant, et al., v. Commissioner,* 366 F.2d 874, petition No. 911, this Term; *Babcock v. Phillips,* petition No. 1215, this Term.

The fundamental fallacy of the courts below and the respondent is illustrated by the following from the opinion of the Court of Appeals quoted at page 10 by respondent:

> "Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48% of the stock in [Old] Reef had their stockholdings completely redeemed. Second, new Reef was formed and the assets of [Old] Reef were transferred to new Reef. The business enterprise continued without interruption during both the redemption and the change in corporate vehicles.
>
> Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a

> standard, these two elements were functionally unrelated. [Old] Reef could have completely redeemed the stock of 48% of its shareholders without changing the state of its incorporation. * * *"

This Court has rejected this line of argument many times. *Commissioner v. Brown,* 380 U.S. 563; *Hanover Bank v. Commissioner,* 369 U.S. 672; *Turnbow v. Commissioner,* 368 U.S. 527; *Helvering v. Flaccus Leather Co.,* 513 U.S. 247; *Helvering v. Hammel,* 311 U.S. 504; *Old Colony Railroad Co. v. Commissioner,* 284 U.S. 552.

This case does not affect Reef Corporation alone. The Government is already asserting in the courts below that all these notes received by Butler, Miller, Lents and Saunders and others of the Butler group were dividends subject to the regular individual tax rates. In other words, Saunders, for example, is being treated as having received a dividend in one year equal to the amount of the notes he received. The tax liabilities on some of these men, if the judgments of the lower courts are sustained in this case, will be catastrophic.

Your petitioner respectfully prays that its petition for certiorari be granted.

Respectfully submitted,

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